LATIN AMERICA AND THE CARIBBEAN

Policies to improve linkages with the global economy

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LATIN AMERICA AND THE CARIBBEAN: POLICIES TO IMPROVE LINKAGES WITH THE GLOBAL ECONOMY

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FOREWORD

Four years ago, the secretariat submitted to the States members of ECLAC the document entitled *Changing Production Patterns with Social Equity*. It offered general guidelines for the development of the countries of Latin America and the Caribbean, including, in particular, the proposal that production should become more internationally competitive, not only in order to increase exports but also to achieve efficient import substitution. At the same time, the document offered a framework for subsequent activities of the Commission revolving around the study of a number of related topics.*

The economic panorama of the region has indeed changed considerably in these four years. Although with certain differences among countries, the macroeconomic disequilibria of the past decade have begun to be corrected; the transfer of resources out of the region has turned around to become a huge net inflow of foreign capital; the export sector has grown and diversified; and economic activity as a whole has shown a modest recovery. The Latin American and Caribbean countries are now feeling the need to build on these advances, some of which are still rudimentary and partial, surmount the difficulty of making headway in highly competitive international markets and overcome the considerable social lags that have accumulated. Their chance of carrying out all these tasks will ultimately depend on establishing better linkages with the global economy.

One of the many conclusions reached in this document is that, notwithstanding the multiple obstacles that impede development in the region, a constellation of potentially favourable factors is also present today which could give this development a strong boost. These include the gradual assimilation of the lessons learned in the process of increasing and diversifying exports; improvement of the quality of macroeconomic management; the chance to fill a gap in public policy instruments in the region —i.e., the implementation of micro- and meso-economic policies— in order to increase productivity in accordance with the best international practices; renewed access to external financing; and a boom in intraregional economic cooperation. Another factor has been the recent adoption of new international trade rules under the

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* Thus, for example, the link between changing production patterns, social equity and the environment was addressed in 1991; in 1992, the existing reciprocal ties between changing production patterns and social equity were examined in further depth; and in 1993, the topic of population was incorporated into this framework. The references for these documents are contained in the bibliography.

Uruguay Round. These rules, although far from meeting all the region's demands, at least represent a step forward in support of multilateralism.

Whether improvements can be made in the participation of Latin America and the Caribbean in dynamic trade flows and in the region's access to technology, foreign direct investment and financing depends in part on exogenous factors which are beyond the control of the countries of the region. However, much remains to be done in terms of both national policies and intraregional cooperation** to enhance linkages with the global economy.

The main purpose of this document is to explore the scope of efforts being made to achieve these objectives. It discusses three interrelated types of policies, namely, trade policy, micro- and meso-economic policy in support of production systems, and macroeconomic policy, with specific emphasis on financial flows. The last one is especially relevant in the current economic environment, in which capital inflows are having a crucial effect on two key variables in the behaviour of exports —interest rates and, in particular, exchange rates.

The document is divided into three parts, one for each type of policy. The introductory chapter not only provides a summary account of the contents of these three parts, but also combines their various components into an integrated, coherent presentation in the framework of the systemic proposal that has been put forward by the secretariat.

It should be noted that this document, like those preceding it, does not claim to offer universal recipes, in view of the enormous diversity of situations in the region. Rather, it seeks to promote a debate on areas of key interest to the various countries in their efforts to improve their linkages with the global economy, as part of the agenda of changing production patterns with social equity.

** The potential for economic integration is the subject of a separate but complementary document. See ECLAC, *Open regionalism in Latin America and the Caribbean. Economic integration as a contribution to changing production patterns with social equity* (LC/G.1801(SES.25/4)), Santiago, Chile, 1994.

SUMMARY AND CONCLUSIONS

A. INTERNATIONAL LINKAGES AND DEVELOPMENT

1. Main features of Latin American and Caribbean linkages with the global economy in the 1990s

1. The linkages between a number of Latin American and Caribbean countries and the international economy have undergone very significant changes in recent years. These include, in particular, the intensification of efforts to export and to liberalize imports, a process that began during the 1980s in several countries and that is becoming more pronounced in the 1990s. For the region as a whole, the volume of exports of goods and services increased by an annual average of 5.3% during the 1980s, and by 6.9% from 1990 to 1993.

2. None the less, the relative buoyancy of the export sector has not always been reflected in the behaviour of the economies as a whole. In the 1980s, gross domestic product increased by only 1.2% a year; from 1990 to 1993, it registered an average annual growth rate of 3.3%. As a result, the export coefficient rose from 14% in 1980 to 21% in 1990 and to 23% in 1993. In other words, the growing importance of the export sector in the region's economies can be attributed in part to the expansion of this sector, and in part to the poor performance of the regional economy as a whole.

3. The reason for this phenomenon is that during the 1980s, in a context of burdensome external debt service and a collapse of the flow of fresh funds to make the necessary economic changes, the countries of the region had to make a recessive adjustment. A good part of this adjustment was based on the sharp contraction of the money supply and fiscal expenditure, and on devaluations in the exchange rate for the dual purpose of slowing down imports and promoting the production of exportables. In the first stages —marked by high costs of domestic finance and scant improvement in productivity—, real wages and employment bore the brunt of the adjustment, and this in turn depressed domestic demand.

4. Thus, although export volumes were frequently dynamic, the opposite was true of production and investment for the domestic market, especially in non-tradables at the international level. Consequently, the economy as a whole, together with investment and total output, tended to slow down despite export growth.

5. A portion of this growth was the outcome of a still incipient change in production patterns, based on an endogenous

process of increases in productivity and encouraged, *inter alia*, by the gradual elimination of anti-export biases in economic policy. The restructuring process also enhanced the competitiveness of a growing number of firms and increased their capacity to explore and penetrate external markets, with considerable variation among the countries of the region. This change in production patterns gained momentum in the 1990s.

6. Part of the impact of the push for exports was also neutralized by the deterioration of the terms of trade that was caused not only by negative trends in the international markets for the region's exportable supply, but also by insufficient diversification of Latin America and the Caribbean's trade structures in favour of exportables having a more stable, dynamic external demand.

7. Since the beginning of the present decade, and owing to a combination of factors, the outward transfer of financial resources that characterized the 1980s has reversed itself, and private external finance has reappeared. Net inflows, which mirror the universal changes taking place in international capital markets, have been based on more diversified sources of finance than before. In particular, foreign direct and portfolio investment have increased in the form of bonds and equities —either directly or as ADRs/GDRs—, and foreign investors are increasingly participating in emerging markets. These phenomena indicate that the region is beginning to use new mechanisms to attract external resources, and that the growing importance of foreign direct investment means not only more resources but also technology transfers in support of the processes involved in changing production patterns.

8. In the new situation of increased capital inflows, most of the economies have begun to recover in a context of greater price stability. However, their growth tends to be much slower than the trend in export volumes would suggest. One reason for this is the deterioration of prices —which fell by an average of 14% just between 1990 and 1993— and the weakness of production linkages between the export sector and the rest of the economy.

9. The reversal of the trend in net external finance from a situation of marked constraint to one of considerable abundance has not been reflected, in general, in investment levels. Available data up to 1992 indicate that gross fixed capital formation stood at about 18% of regional gross domestic product, somewhat higher than the average of 17% in 1983-1990 but much lower than the 24% registered in the five-year period 1976-1980. The growth of the investment coefficient has been significantly lower than the increase in resources from abroad, because part of these resources had to be spent to offset the deterioration of the terms of trade, while another part was used to finance more consumption, especially of imported goods.

10. Because of their high volume, these flows have also had some undesired effects in a number of countries, especially on the exchange rate and money supply, and have increased the countries' vulnerability to external shocks. In some cases, these effects have undermined the objective of protecting the tradables sector of the economies and, as mentioned above, have diverted national saving to the consumption of imported goods.

11. In general, the economic policy adopted by the countries of the region has underlined the need to export more goods and services and to do it better. In a situation where imports are expanding faster than exports, and where there is a growing deficit in the region's current account, an increase in export volume increasingly appears to be a macroeconomic requirement for sustaining the recovery of growth. It would also be useful to strengthen the ties between export sectors and other production sectors, because such linkages lead to intermediate demands for goods, services and labour, quality improvements and absorption of technological progress.

2. The international scenario

12. The international scenario will present new challenges and opportunities for Latin America and the Caribbean in the foreseeable future. Four features of world economic trends in the 1990s stand out: i) slower growth in the industrialized economies in comparison with previous decades, and recession in the transitional economies; ii) stronger trends towards globalization and technological change; iii) realignment of the major markets, with Asia becoming more important in global economic dynamics, and with many developing countries seeking to improve their linkages with international markets; and iv) an impressive expansion of international capital mobility and the creation of mechanisms to facilitate this expansion.

13. One of today's leading trends is globalization, as can be seen from the increase in trade volume compared to global output, the boom in foreign direct investment (FDI) and the enhanced importance of transnational corporations, the much more flexible, dynamic financial system and the new international organization of production and trade characterized by the importance of subcontracting and intra-industry (and intra-firm) trade. This globalizing trend is not immune to the tensions produced by trade imbalances in the countries of the Organisation for Economic Co-operation and Development (OECD), especially the high surpluses in Japan and the deficit in the United States, the persistence of protectionist attitudes and the latent risk that agreements among groups of countries will lead to more closed economic blocs.

14. Technological change, for its part, offers many opportunities and also some risks. In growing economies, it favours the net creation of jobs in the medium term, but may act in the opposite direction in the short term. This risk is higher if global investment is relatively low. It is worth noting that the most important impact of the current technological cycle on employment is not the loss of jobs but the obsolescence of certain skills and know-how. Consequently, some jobs are eliminated and others are created which require new skills that workers who are currently unemployed or those who have been displaced by technical or organizational change do not necessarily have.

15. Notwithstanding the foregoing, the recent signing of the Final Act of the Uruguay Round of GATT, together with the ratification of the North American Free Trade Agreement by Canada, the United States of America and Mexico, constitute (for different reasons) a reaffirmation of multilateralism which is consistent with the globalization process. The adoption of new rules, procedures and institutions to govern contemporary international trade is a promising —although still imperfect— point of departure for the efforts being made throughout Latin America and the Caribbean to improve the region's linkages with the global economy.

B. POLICY GUIDELINES

1. Introduction

16. To make sustainable changes in production patterns with social equity, the economies of the region must improve their linkages with the international economy, i.e., their participation in dynamic flows of trade, foreign direct investment, technology and finance. These linkages should enhance the countries' capacity to take advantage of expansive cycles in international and regional trade and to cope with adverse cycles and financial instability by diversifying products and markets, seeking investment and alliances abroad, applying domestic stabilization mechanisms and improving the coordination of exports with other productive activities.

17. What is required in order to make a quantitative and qualitative improvement in the linkages of the Latin American and Caribbean economies with economic globalization is a simultaneous, coherent effort in a number of policy areas, within the framework of the systemic approach proposed by the ECLAC secretariat. These areas include policies on trade, exchange rates, productive development and finance and, in particular, the interaction among the policies themselves. In other words, for these policies to be effective and efficient, none of the areas can be addressed in isolation from the rest.

18. Indeed, the effects of micro- and meso-economic policies that ignore the macroeconomic environment will be weakened. To base them exclusively on trade policies, disregarding the expansion of production and the macroeconomic environment, may, at best, promote export growth, but this may not necessarily invigorate the rest of the economy. On the other hand, limiting export promotion to trade reforms and the preservation of macroeconomic equilibrium may lead to stability but not growth, and still less to the stimulation of endogenous processes of improved productivity and competitiveness.

19. There are, of course, no universally valid paradigms for improving international competitiveness; the experiences of East Asia show that, although there may be a common denominator in the general approach, different paths have been taken in terms of the details of policy implementation, instruments and institutions. With this caveat, the subject areas and proposed policy guidelines contained in this document are presented below.

2. Integrated trade reforms

a) A strategy for enhancing the region's integration with the global economy

20. The modernization of trade policies requires more, of course, than just removing import restrictions: this is only a starting point. In addition, a strategy must be developed for improving the region's linkages with international markets, which would then be implemented on the basis of a series of coherent guidelines and measures that would persistently and energetically help promote the production of goods and services with export potential.

21. Tariffs, non-tariff measures and incentives to produce non-traditional exports are core components of any trade policy. Together with the exchange rate, they influence the net incentive to export or to substitute imports. The anti-export biases of this combination of incentives must be eliminated. It would even be advisable to introduce temporary biases in favour of non-traditional exports, which would be consistent with a reasonable degree of transitory protection for other activities; this would create a mix of selective policies geared towards overcoming market shortcomings and taking advantage of clear externalities.

22. One expression of the selectivity referred to above is found in the reformed tariff structures in the region in recent years. Many Latin American and Caribbean countries have drastically reduced their high tariffs and have considerably narrowed the distance between minimum and maximum levels. However, the great majority of them have retained a certain moderate differentiation, with only a few brackets, which is justified on the basis of externalities and deficiencies in factor markets (technology, finance and training) and product markets (economies of scale and dynamic externalities).

23. A bias persists, in many cases, against the value added in the production and sale of exportable goods and services, although it is clear that this bias has been significantly reduced. The new tariffs, although they tend to be moderate, are usually above zero, and do not always have an equivalent counterpart in incentives to compensate exporters. Added to this, in general, is the failure to provide compensation to pioneer exporters for the externalities they generate, even though

their activity has all the hallmarks of an "infant industry".

24. The first firms to identify a new product which the country can produce efficiently and sell on international markets at competitive prices are real innovators. They become liable to the costs and risks of penetrating a new market; once they have done so, other firms benefit from the innovator's efforts. Pioneer exporters therefore deserve to receive incentives so as to be able to meet the high initial costs of penetrating markets, and should be compensated for the positive externalities they generate for the other firms that imitate them.

25. Promoting the international competitiveness of a country's products and of its non-traditional exports necessarily forms a part of the policy mix aimed at implementing a strategy to change production patterns. Experience shows, however, that incentives —both to enhance international competitiveness in domestic activities and to promote non-traditional exports— should be circumscribed, be limited in time, deviate moderately, and only selectively, from neutrality and offset the specific anti-export biases of protection.

26. The outcome of trade liberalization and its evolution are influenced by each country's structural features, its economic situation and the mix and sequencing of policies. However, opening up an economy to imports is not enough to raise export volumes and output growth rates significantly. There is a clear need for complementary measures which are directly aimed at promoting exports, easing the restructuring of import substitutes and improving systemic competitiveness.

27. It is important to send out clear signals on the significance of investment and innovation in expanding and improving export capacity, and of restructuring and rationalizing the sectors that produce importables. A well-balanced management of the exchange rate, a gradual overall reduction of protection levels, effective export promotion mechanisms and a productive development policy will be crucial elements in achieving this objective.

28 Exchange rate or investment policies should not respond passively to misleading short-term signals, such as a temporary increase in exports resulting from an initial recession or from the elimination of artificial obstacles, or the failure of imports to react immediately to liberalization, also because of a recession or lack of marketing channels.

29. Reform processes in which decisions are shared with private agents are less traumatic, since they make it possible to adjust to the new conditions at the micro-economic and sectoral levels. If trade liberalization is accompanied by consistent macroeconomic policy and credibility in government action, there are better chances of working together to reduce the costs of adjustment.

b) Exchange rate policy and trade reforms

30. Tariff reductions should be accompanied (if not preceded) by a compensatory variation in the real exchange rate. Easing access to imports, associated with an appreciation of the exchange rate (and the use of exchange policy to stabilize prices), is usually a dangerous combination for the equilibrium of the balance of payments and for productive development.

31. A *sine qua non* for the success of trade reforms, whether these involve a drastic liberalization or a gradual opening and whether they are integrated or only partial, is to avoid exchange rate appreciation. The experience of a number of Southern Cone countries in the period 1976-1981 illustrates how harmful the dual impact of real exchange rate appreciation and drastic liberalization of imports can be. To enable the Latin American economies to produce tradables, a favourable, stable real exchange rate must be maintained, i.e., an exchange rate which, as a reflection of the basket of currencies used in the country's foreign trade, fluctuates

on the basis of long-term factors, is relatively independent of temporary economic conditions and is not overly correlated with short-term capital movements.

32. The impact of exchange rate policy on the various sectors is heterogeneous. The greater the diversification and installed capacity of the industry, the more sensitive it will be to exchange rate policy. It has been shown that the elasticity of the manufacturing sector in relation to the exchange rate (and equivalent incentives) is systematically higher than the elasticity of total exports, in both the long and short terms; this sector's velocity of response is also higher, especially in countries where industrial diversification and expansion of production capacity have historically been greater.

33. A number of empirical studies also show that a stable real exchange rate, at a remunerative level for producers of tradable goods and services, is essential to the success of a trade policy geared towards changing production patterns. Exchange rate instability tends to hurt investment, especially in non-traditional exports, since the process of launching products in international markets is usually costly, and investors will not take the risk without being fairly certain that the venture will be profitable.

34. One of the key economic policy challenges in the region, which arose in the early 1990s, is to find a way to maintain trade liberalization together with either depreciation or stability of the exchange rate in a situation of huge net capital inflows. To this end, besides regulating the inflows, domestic saving must be encouraged in order to maintain the real exchange rate at a competitive level, in line with medium-term factors.

35. Most of the recent liberalization experiences in Latin America have taken place in economies whose exchange rates had previously depreciated sharply as a result of the external debt crisis of the 1980s and the shortage of external finance. Under current reforms, however, the effects are being produced in a context of a strong real exchange rate appreciation in the 1990s, associated with voluminous inflows of external capital, much of which is short-term. Systematic data for 17 Latin American countries indicate that 12 of them have experienced significant revaluations of their real exchange rates during this decade. It is worth repeating, however, that these revaluations occurred following considerable depreciation. With regard to capital movements, it is noteworthy that net inflows in 1992 and 1993 represented a similar proportion of GDP as in the period 1977-1981, and quadrupled the low average of 1983-1989.

36. To sum up, there are no good substitutes for exchange rate stability, especially in economies such as those of Latin America, for which a qualitative improvement in international linkages is a decisive factor in their development strategy. Hence the importance of linking trade policies with those designed to expand production and gain a better international financial position by stimulating domestic saving, fostering a comprehensive development of the country's capital market, reducing its segmentation and adapting the level and composition of external capital inflows to the domestic capacity to absorb them.

c) Anti-dumping regulations, countervailing measures and safeguard clauses

37. Liberalizing their trade policies and import regimes has made Latin American economies more vulnerable to unfair trade practices and the instability of their trading partners. It is therefore essential that the countries of the region adopt or improve anti-dumping regulations, countervailing measures and safeguard clauses, without, however, allowing private interests to use the new provisions in these areas to introduce undue regional protectionism.

38. Under the Uruguay Round, new international regimes have been adopted in

each of these fields. Accordingly, the regulations which countries adopt in this area will have to be compatible with the commitments made. While it is true that the new regimes will determine the kind of mechanisms that the countries of the region can establish, they will also limit the arbitrary treatment sometimes faced by Latin American and Caribbean exports in extraregional markets.

39. The issue of fair competition is becoming increasingly relevant in the context of current regional integration agreements leading to total liberalization of the corresponding markets. It is particularly important that the safeguard mechanisms adopted in Latin America and the Caribbean to avoid exceptional short-term problems should not interfere with the long-term benefits that can be expected from intraregional integration programmes (see ECLAC, 1994a).

40. The adoption of the new regulations emanating from the Uruguay Round could limit the possibilities of implementing an active trade policy in the region, particularly for the promotion of non-traditional exports. However, those regulations do make certain exceptions for the developing countries, and the countries of Latin America and the Caribbean should take advantage of them to promote their exports, without infringing multilaterally agreed rules.

41. In this connection, the countries of the region should evaluate carefully the new opportunities for market access afforded by the results of the Uruguay Round, examine the possibilities and restrictions created by the new multilateral regime and rethink many of the issues related to the latitude they enjoy for formulating policies on trade and productive development. For example, such policies must consider their new linkages with the environment and social rights.

42. These observations hold true not only for the action to be taken immediately following the conclusion of the Uruguay Round, but also for future international negotiations, particularly those on free trade agreements with developed nations. They also hold true for making better use of generalized systems of trade preferences, especially in cases such as that of the European Union, which in 1994 will define its new system of preferences for the developing countries.

d) Export-promotion policies

43. The countries of the region should have active export-promotion policies. As mentioned above, the main reasons for implementing such measures are the need to offset the anti-export bias inherent in tariffs, alluded to in earlier paragraphs; the positive externalities generated by export activity; the shortcomings in capital markets for financing exports; and the economies of scale and learning opportunities that exporting provides. Without an active export-promotion policy, exports will tend to be concentrated in a few enterprises and on products for which demand is less dynamic and which are more vulnerable in global markets.

44. One basic prerequisite for promoting the competitiveness of export firms is to guarantee them access to inputs on competitive terms. These firms should have access to flexible mechanisms for importing inputs on a temporary basis to produce exportables, once certain basic requirements have been met. Other alternatives are tariff exemptions or drawbacks, with a minimum of red tape. Such mechanisms could also be applied to indirect exporters (domestic producers of inputs for exporters).

45. The governments of the region could support pioneer export firms by providing incentives for exports of new products or for penetrating new markets. One mechanism is a "simplified drawback" for products whose export level is below a given amount for a specific period. These incentives should be moderate (helping to place competitive or near-competitive products in foreign markets), limited in time, and subject to precise re-

sults in terms of new products, amounts or markets.

46. The public sector can help improve performance in foreign markets by providing institutional support for export activity, especially in the areas of information, financing and export insurance; management training to encourage businesses to focus on exporting; and promotion of the exportable supply abroad. Pioneering efforts are also being made in such areas as investing abroad to support export activities, marketing chains, joint ventures with firms in target markets and other mechanisms that export-promotion policies are beginning to consider.

47. The development of the exportable supply within the country should also be actively supported, in order to adapt it to the demands of foreign markets. Timely, up-to-date information on the requirements of export markets in terms of quality, environmental regulations, standardization, deadlines and volumes would facilitate this task. It would also be useful to promote ties between domestic firms and international trading companies, particularly in sectors in which the country has export potential. Besides laying the bases for strategic export alliances between domestic and foreign firms, these ties also stimulate steady quality improvement and the development of new products, making domestic firms more flexible in responding to new commercial opportunities.

48. Past export-promotion policies often neglected sectors based on natural resources. Recent technological advances in microelectronics, data processing, telecommunications and satellite technologies considerably augment the supply of information on the quality and volume of economically available natural resources. This is one more reason for acquiring and strengthening comparative advantages in non-traditional natural resources with significant economic rents.

49. To be effective, an export-promotion system must be somewhat selective. It is impossible to promote everything indiscriminately. The selection of sectors, and export-promotion decisions in general, should be made in close, systematic cooperation between the public and private sectors. Exporters' associations should therefore be strengthened.

50. Many countries have recognized the advantages of consolidating into one institution the various agencies that support non-traditional exports. These agencies should be financially stable and have qualified professional staff, so that they can have more influence on policy decisions affecting exports.

3. Meso- and micro-economic policies for productive development

51. One of the main concerns of the ECLAC secretariat throughout the past decade has been to enhance international competitiveness by applying technical progress to the production process. The secretariat has emphasized repeatedly the systemic nature of the effort required to close the present gap between the "best international practices" and the average total productivity of factors in the countries of the region.

52. It has also insisted that becoming internationally competitive, either in exports or in efficient import substitution, requires not only suitable macroeconomic and trade policies, but also micro- and meso-economic policies; in other words, the enterprise itself must be modernized (technology, equipment, organization, labour relations), as must its environment (factor markets). The pace of restructuring, and in some cases the very survival of the firm, will depend essentially on the information and human and financial resources at its disposal.

53. The more distorted the factor markets and the greater the uncertainty about the seriousness of the adjustment and liberalization process and the stability of the prevailing key prices, the greater the likelihood that potentially competitive firms

will fail, for lack of time and resources, to undertake the restructuring needed to acquire a comparative advantage in the domestic or foreign market.

54. This is why it is important that key markets —those for technology, physical capital, human capital and foreign exchange— should function at near-optimum levels. Horizontal policies are needed to achieve this, namely policies designed to fill in the main gaps and resolve the main bottlenecks in those markets. The difference between today's productive development policies and the "industrial" policies of the past is, precisely, the importance they attach to improving factor markets, with a view to narrowing or eliminating the gap between the average productivity of the region and that obtained using the best international practices.

55. Latecomers to development like the countries of the region have tremendous latent potential for increasing their productivity. Narrowing the gaps mentioned in the preceding paragraph —in other words, modernizing— demands an active learning and restructuring process in the areas of technology and organization, as well as in quality-control systems and selling on new markets. All of this entails a major investment in time and capital, both physical and human, especially by firms that are lagging technologically. The essence of a modern productive development policy is that it facilitates this learning process, as experiences in other parts of the world and even some in the region show (motor vehicles and parts, wood, paper and pulp, for example).

56. Productive development policies are designed to reinforce, rather than replace, market forces. Any incentives should also be temporary. An orientation towards international competition promotes a business attitude centred more on productivity than on short-term profitability, seeks levels of output that result in economies of scale (either because there is a large domestic market, because the original orientation was towards exports or because the activity involves the continuous processing of a natural resource that can easily be exported if domestic demand is insufficient) and tends to adopt relatively advanced but tried and tested technologies (technology is mastered, updated and even adapted, as necessary).

57. Building on the ideas put forward in *Social Equity and Changing Production Patterns: An Integrated Approach* (ECLAC, 1992a), three sets of measures can be proposed, given their special relevance to productive development policies in support of international competitiveness. The first set of measures covers technological development policies; the second, manpower training; the third, improvements in long-term capital markets. A practical programme is also suggested for putting the region's entrepreneurs in touch with the best international production practices.

58. The following policy options are proposed for *technological innovation and dissemination:*

i) Implement domestic competition policies that go beyond mere trade liberalization.

ii) Partially subsidize firms' technological innovation and development activities, whether these are carried out by them directly or in conjunction with research centres, taking into account the important positive externalities that flow from these activities.

iii) Develop and strengthen systematic monitoring of the technologies and management methods available internationally, and integrate firms into the relevant information networks, bearing in mind that each firm should be able to make the most informed choice possible as to the technology it decides to apply.

iv) Ensure better financing for technological development efforts, paying particular attention to the needs of small and medium-sized firms. Such efforts include the development of prototypes and pilot plants to facilitate the transition from research to applica-

tion. The sums needed may be relatively small, the main idea being to demonstrate to private banks that this kind of investment can be profitable and to serve as a tool for learning how to evaluate technological risk.

v) Acquaint businessmen and economic agents in general with the most promising experiences in developing and disseminating technology —technology centres for each branch of industry, think-tanks, industrial parks, links between universities and business, and alternative financing mechanisms— in order to increase the impact of these experiences.

vi) Promote strategic alliances between domestic and international firms that are leaders in technology, management, quality and access to the most important markets, by simplifying administrative procedures, improving information and providing tax incentives.

59. With respect to *training*, which is sorely lacking in the region despite the demonstrably high returns on investment in human capital, and also despite the fact that manpower capacity is a key to productivity, the following measures are proposed:

i) Provide tax and monetary incentives to firms that train their staff, to offset the negative externality that such training generally creates (training tends to benefit the worker far more than the firm that trains him).

ii) Undertake promotional and publicity measures to accelerate the use of training incentives and to introduce more efficient human resources management practices and more cooperative industrial relations.

iii) Reorganize the supply of training, promoting private sources and concentrating public efforts on bringing instruction, and instructors, closer into line with the production system and its future needs; ensure the quality and relevance of the courses offered, establishing mechanisms for certifying the training given; and promote and finance training opportunities for marginal or unemployed workers or those employed by small firms, who are not usually reached by such programmes.

iv) Promote special basic training programmes for the large segment of the labour force (40% in the region) that have not completed their primary education, and subsidize regular programmes to help raise the productive potential of this huge group of workers, who will be unable to benefit from any educational reforms that are implemented.

60. The lack of a long-term *capital market* means that the extent to which most firms in the region are equipped, modernized and expanded depends on their ability to finance themselves, not on their future prospects, and this leads to inefficient allocation of capital. This problem is aggravated during periods of restructuring: the fact that a firm has abundant capital (which may be a reflection of its past success) does not always mean that it has a potential for success in the future, yet firms that have such capital tend to invest it in their own activity. They may even overinvest in obsolete activities, to the detriment of other activities with better chances of being modernized and restructured.

61. Lastly, one specific proposal for narrowing the gap between the productivity of many of the region's firms —except for those on the leading edge of their respective branches— and that of the developed countries is to implement massive *extension programmes*, which would co-finance visits to foreign firms where the "best international practices" are to be found.

62. The proposal involves organizing and helping finance visits by managers, engineers, technicians, supervisors, workers and trade unionists, from various production subsectors, to foreign plants where the best practices prevail. On their return, participants would write a report on the best practices with respect to equipment and technologies, production methods, organization of work, industrial

relations, quality control, marketing and other aspects. Each of them would disseminate the results of their visits among other firms and the respective business associations and trade unions. The programme would be open to any sector willing to pay its share, whether it was involved in exporting or in import substitution.

4. Capital movements and macroeconomic policy

a) Economic policy and access to international financial markets

63. In the context of the policies under which trade liberalization was implemented, most governments also applied policies to reduce or eliminate restrictions on international capital movements. This initiative, combined with growing macroeconomic stability, investment opportunities and, particularly, the differential between interest rates in the countries of the region and those in external financial markets, helped to strengthen the trend in these markets towards the resurgence of a significant flow of private funds to developing economies. The combined effect of these changes in the international arena and in the region's economies has led to the re-emergence of net capital inflows in the past three years.

64. International capital mobility plays a number of highly significant roles in development. Two of these are notable for their macroeconomic effects: i) the channelling of external savings towards countries with insufficient capital; and ii) the compensatory financing of external shocks, which helps to stabilize domestic spending. In Latin America and the Caribbean, external capital has played a positive role in both of these areas in the 1990s, even though only a small fraction of net inflows have translated into an increase in productive investment.

65. It is clear, then, that the capacity to attract external financial flows does not, in itself, ensure that savings and investment processes will automatically be strengthened. This is because domestic and external financial markets have serious imperfections, which limit their ability to allocate resources efficiently, especially to investment in tradable sectors. In this context, a coherent, sustained economic policy can play a vital role in achieving more dynamic and stable development.

66. Moreover, the soundness of economic policy cannot be evaluated solely on the basis of access to external flows, especially during cycles when international funds are in abundant supply. Above all, it is important to consider the capacity of national authorities to maintain macroeconomic stability and the incentives for economic agents to take decisions based on sustainable medium- and long-term goals. Intervention to manage the effects of capital flows is justified in so far as the latter simultaneously affect two key variables for efficient resource allocation: the real exchange rate in the foreign exchange market, and the real interest rate in the money market.

67. In this regard, it should be recalled that Latin American history has been marked by periods of large-scale capital inflows, followed on a number of occasions by periods of debt crisis. This has sparked a wide-ranging debate on the dynamics of the process of opening up the capital account. Today, it is generally agreed that this process should be implemented sequentially, and that it should occur after other liberalization processes, particularly those affecting trade and the domestic financial market, have been consolidated.

68. With respect to the speed at which the capital account should be liberalized, in order to maintain macroeconomic balances and a stable real exchange rate, the process must be tailored to the economy's capacity to absorb and efficiently allocate external resources. It may be desirable to liberalize the entry of long-term capital first, before facilitating transactions involving short-term financial capital. With respect to capital outflows, priority should

be given to credits for export promotion, and to direct investment abroad by national firms, which is another way of improving their export platform.

69. Capital-account liberalization in the industrialized countries has been fairly slow and gradual, accelerating only in the past 10 years as capital markets have become globalized. However, it is interesting to note that Spain, Portugal and Ireland introduced certain restrictions on capital movements in 1992 to deter exchange rate instability. Once the objectives of stability were achieved, the restrictions were lifted. This highlights the importance of flexible instruments that, according to circumstances, allow some temporary restrictions to be imposed on capital movements to support efforts towards macroeconomic stability.

70. The economic recovery taking place in a number of countries in the region, based on the removal of external restrictions, is obviously limited by available productive capacity. Some countries have been gradually approaching their production frontier. On the one hand, this creates a need to regulate patterns of aggregate demand so as to avoid renewed bouts of inflation or excessive deficits in the external sector. On the other, it heightens the urgency of boosting investment to sustain GDP growth with increases in productive capacity and in the production of tradables. As the debt crisis is resolved, this is the area on which the macroeconomic policies of the countries of the region will have to focus.

71. Promoting a strategy of changing production patterns with social equity also requires, at the macroeconomic level, efforts to manage aggregate demand and its composition. The instruments available for this purpose are fiscal, monetary and exchange rate policies. In the absence of an active fiscal policy, these instruments are reduced to simultaneously controlling the real interest rate (as a monetary policy instrument to stabilize and control aggregate domestic expenditure) and the real exchange rate (as a trade policy instrument to promote the growth of tradables production and influence the composition of aggregate expenditure).

72. A conflict arises when an interest rate consistent with the objective of curbing inflation and stabilizing economic activity (by sterilizing the monetary effects of accumulating reserves) is higher than the international rate, adjusted for expectations of devaluation, thereby providing an incentive for capital inflows and promoting exchange rate appreciation, thus jeopardizing the objective of protecting the economy's tradable sector. Conversely, if, in the particular situation just mentioned, real domestic interest rates are allowed to fall, both objectives are thwarted, since the higher expenditure induced by lower interest rates will put pressure on prices and rapidly boost the current account deficit, threatening to cause an unsustainable macroeconomic imbalance. The authorities can resolve this conflict by acting directly or indirectly on capital flows, as some Latin American and Caribbean countries have been doing in the 1990s.

73. One of the main questions faced by the region's governments in designing economic policy concerns the possibility of distinguishing, on the one hand, between domestic and external factors that explain the resurgence of capital movements in the region and, on the other, between short-term capital flows (which tend to be more speculative) and medium- and long-term flows (more closely associated with productive investment). From this viewpoint, it would be desirable for external financing to contribute to the investment process needed to strengthen productive competitiveness, meaning that the entry of long-term capital should be stimulated and that of speculative capital should be discouraged.

74. When the authorities are faced with an unexpected abundance of external financing which they consider to be partly transitory or as flowing too fast for the economy to absorb, they can intervene at three levels. At the first level, they can act

to moderate this inflow's impact on the exchange rate through the purchase of foreign exchange (i.e., the accumulation of reserves) by the central bank. At the second level, they can adopt sterilization policies to mitigate the monetary impact of the accumulation of reserves at the first level of intervention. At the third level, they can adopt policies on incentives, surcharges or quantitative controls to regulate inflows of capital, thereby influencing the latter's composition and volume, the aim being to encourage flows whose volume is compatible with the economy's domestic absorptive capacity, channelling them into productive investment projects, and, conversely, to discourage the entry of short-term speculative capital.

75. In sum, governments have two options. Some have adopted so-called non-sterilized intervention, meaning that they intervene at the first level by having the central bank buy foreign exchange, without sterilizing the resulting monetary effect. In choosing this option, while also liberalizing capital movements and maintaining a nominal exchange rate with a predetermined rate of variation, the authorities lose control over monetary aggregates. The other option is the so-called sterilized intervention, which broadens the scope of the first option by offsetting the monetary impact of the accumulation of reserves with active operations to regulate the money supply. This is intended to keep the real exchange rate within desirable limits according to medium- and long-term objectives, and to regulate aggregate demand at levels compatible with sustainable macroeconomic equilibria.

76. The sterilization option entails certain costs, since the interest rates which the central bank pays on its notes are higher than those it obtains on its placements in foreign currency. These costs are not necessarily permanent if the central bank maintains a real exchange rate, pegged to a currency basket reflecting the composition of the country's external trade, that is sustainable in the medium term. The bank can facilitate its task, and reduce its costs or even turn them into profits, by adopting a policy of "dirty" floating within an exchange rate band: it can earn profits by buying and selling foreign exchange, thereby offsetting losses attributable to the interest rate differential.

77. Since most countries in the region have at some point opted for sterilized intervention, they have faced serious conflicts between exchange rate and monetary management. To moderate such conflicts, they have used complementary measures, such as providing for a degree of flexibility in fiscal policy to regulate aggregate demand; stabilization funds for the main export products to soften shocks in their price cycles (as in the case of Chilean copper and Colombian coffee); and income policies to adapt the relative prices of factors to changes in productivity.

78. As mentioned earlier, when fiscal policy has no instruments through which it can act flexibly, monetary policy (interest rates) and exchange rate policy (exchange rates) are the only means of controlling aggregate demand. To resolve the conflict that could arise in the simultaneous management of these two variables, the authorities have the option of intervening at the third level with measures intended to change the volume and composition of capital flows, giving priority to long-term flows through incentives (reserve requirements or taxes, and exchange rate measures that generate more uncertainty for short-term capital flows) or even via quantitative controls.

79. Direct quantitative controls include requirements as to minimum maturity periods; minimum volumes for bond issues; caps on interest rates on foreign capital; and regulations on the participation of foreign capital in the stock market.

80. In the current circumstances of abundant external funds and comparatively low international interest rates, third-level intervention policies and sterilized intervention act on monetary aggregates to prevent excess expenditure (especially private spending), forestalling

artificial, temporary increases in domestic spending which could cause severe declines in national savings and excessive increases in external liabilities, without a corresponding increase in the capacity to produce tradables.

b) Improvement of domestic financial markets

81. The extent to which flows of foreign capital can further a strategy of changing production patterns with social equity largely depends on the characteristics of domestic financial markets. This observation is based on the experience of the external debt crisis, which resulted from large-scale inflows of foreign bank credits. On that occasion, capital markets were unable to avoid generating "financial bubbles", adverse selection and moral hazards, features inherent in financial markets.

82. The challenges of ensuring prudential financial regulation of domestic financial markets become apparent when consideration is given to the speed with which external funds can flow into those markets. Unless financial institutions and instruments —including public regulatory and supervisory institutions themselves— are actively developed, the intermediation of these funds by fast-growing financial systems could cause distortions and macroeconomic instability by channelling them into high-risk credits ("credit bubbles"), sharply raising the prices of existing shares ("stock market bubbles") and raising the prices of real estate and other assets.

83. As suggested in the comments on policies for productive development, the reorganization of financial systems, including the liberalization of capital movements, should give priority to channelling resources into savings and investment, in close coordination with the development of productive capacity. This role has not been sufficiently emphasized in the region's financial reforms. The relationship between the financial system and national savings and investment processes, and between that system and external financial markets, must be considered more carefully.

84. As regards the relationship between financial markets and capital formation for development, an institutional framework is needed to complete or perfect markets according to three criteria. First, it must include a dynamic long-term segment of the financial market in order to finance productive projects. This involves discouraging speculative segments and concentrating on long-term international capital accompanied by access to technology and to export markets. The impact of capital entering the region through foreign direct investment is important in this context.

85. Second, it must promote access to financing for small and medium-sized firms hurt by the segmentation of the capital market. To that end, this market must operate with some selective criteria that target the training, development promotion and modernization needs of small production enterprises. Credit institutions and guarantee mechanisms are needed to do what the region's capital markets have failed to do spontaneously. The aim is not to subsidize the cost of credit, but to promote access to financing at normal interest rates, as well as the access to technology, inputs and services, marketing channels, long-term financing and infrastructure that will enhance the productive capacity of these sectors.

86. Third, it must recognize that, in countries with "emerging" stock markets, financial liberalization of the capital account by opening it to international portfolio investment runs the risk of creating external over-indebtedness and excessive stock market and exchange rate fluctuations. Large-scale inflows of foreign capital to domestic markets can trigger both "stock market bubbles" and exchange rate appreciations at the same time. The subsequent decline in stock market levels can, in turn, cause capital outflows and devaluation pressures on the exchange

rate. This means that financial institutions operating in capital markets must be regulated and supervised to ensure their stability.

87. Prudential financial regulation can counter these risks and contribute to an orderly, stable process of attracting portfolio investments from abroad. To that end, as noted earlier, financial regulations can act on two key financial variables —interest rates and exchange rates— by establishing bands for these values, or certain rules governing their behaviour. These variables can also be influenced indirectly by means of regulations affecting the availability or cost of funds, including certain restrictions on access, reserve requirements and taxes. The norms governing a country's capital inflows and outflows, whether of foreign or national funds, are part of these regulations. In order to design such norms, the relevant institutions need to have statistical information on external flows (types of flows, volumes, costs and sources) and on the accumulation of stocks of external liabilities in the national financial market.

88. Prudential regulation focuses mainly on ensuring the solvency of the banks, financial funds, insurance companies and other agents that manage resources or assume third-party risks on a large scale. Since the performance of these functions relies on public confidence, the solvency or stability of financial institutions entails significant macroeconomic externalities.

Part One

TRADE POLICY

Chapter I

TRENDS IN THE INTERNATIONAL ECONOMY

1. General considerations

Much has been written about the sweeping changes in the international economy in recent times, in such fundamental areas as production, marketing, transport, transfer of technology and international capital movements (Ohmae, 1985; Porter, 1990; United Nations, 1991; and UNCTAD, 1993). Attention has also been drawn to the challenges posed by the intensely competitive international economy for the countries of Latin America and the Caribbean, and the new opportunities that have opened up (ECLAC, 1990a and ECLAC, 1992a). This chapter discusses some of the more important trends as background for the rest of the volume.

First of all, the international economy as a whole, and the main industrialized economies, have registered very modest growth rates in the last three years. At the time the present document was drafted, the United States economy was finally recovering, but growth rates of only around 3% were predicted for the next few years. Moreover, the difficulties of German reunification were preventing Europe from expanding as rapidly as had been expected, and the Japanese economy was experiencing a recession without precedent in the post-war era.[1] The economic reforms in Eastern Europe and in the former Soviet Union, originally expected to provide an important new market for the exports of Western countries, now constitute one of the factors explaining the slow evolution of the world economy (see table I.1).

The only area which has avoided these problems is a part of Asia. For more than a quarter century, the economies of East Asia have been growing at a rate well above the world average. Using a strategy based on investment in human capital, close and harmonious relations between business and the public sector and competitiveness via exports, these nations have become the world's most powerful in economic terms. Japan, in particular, despite its current difficulties, presents the United States and Europe with challenges that would have been unimaginable a few decades ago. But this is not only a Japanese

1 Markets for the exports of developing countries are still mainly in the industrial world, in spite of the recent increase in trade among the developing countries and the exceptional boom in intra-Latin American trade. In 1992, for example, 59% of the exports of the developing countries went to the United States, Japan, the European Community and eight other industrialized nations. The growth rates in these countries are therefore of great importance because they determine most of the demand for regional exports, the terms of trade and the extent of protectionism.

Table I.1
GROWTH ESTIMATES AND PROJECTIONS FOR THE WORLD ECONOMY, 1993 AND 1994
(Annual growth rates, per estimates of different sources)

	1993			1994		
	UN[a]	IMF[b]	OECD[c]	UN[a]	IMF[b]	OECD[c]
Output						
World output	1.0	2.2		2.5	3.2	
Industrialized countries	0.9	1.1	1.1	2.2	2.2	2.1
United States	2.8	2.7	2.8	3.1	2.6	3.1
Japan	0.0	-0.1	-0.5	1.5	2.0	0.5
Germany	-1.0	-1.6	-1.5	1.5	1.2	0.8
EEC	-0.3	-0.2	-0.2	1.6	1.6	1.5
Developing countries	5.3	6.1		5.3	5.5	
Africa	1.9	1.6		2.5	2.6	
Latin America	3.1	3.4		3.0	3.5	
Asia		8.7			7.1	
Economies in transition	-10.4	-10.2		-0.8	-1.1	
World trade (volume)	**3.4**	**3.0**	**2.6**	**5.9**	**5.0**	**5.4**

[a] United Nations, *The World Economy at the end of 1993: Short-term Prospects and Emerging Policy Issues*, Department of Economic and Social Information and Policy Analysis (DESIPA), New York, December 1993. [b] IMF, *World Economic Outlook*, Washington, D.C., October 1993. [c] OECD, *Economic Outlook*, Paris, December 1993.

phenomenon. Four newly industrializing economies (Republic of Korea, Taiwan Province of China, Hong Kong and Singapore) have demonstrated great skill in production and trade, and this group has now been joined by China and the countries of South-East Asia. Together, these countries form the region where the greatest dynamism is expected during the rest of the decade (see table I.2).

All of the foregoing is occurring in an environment of increased globalization[2] marked by a rise in the volume of trade *vis-à-vis* world production and great dynamism in foreign direct investment (FDI). It is characterized, likewise, by a growing role for transnational corporations in world production and trade, a much more flexible financial system and a new international organization of production and trade characterized by an emphasis on subcontracting and an increase in the magnitude of intra-industry (and intra-firm) trade. At the same time, the intense debate which arose in the last months of 1993 concerning the signing of the Final Act of the Uruguay Round and the ratification by the United States Congress of the North American Free Trade Agreement (NAFTA), as well as the resistance to the deepening of the European Union, show that protectionist pressures and the risks of managed trade remain latent. The external imbalances in the OECD countries, especially the large surpluses in Japan and deficits in the United States, compound those risks.

The effects of technological advances are also ambiguous. Technological

2 This globalization is reinforced by the new GATT agreement.

Table I.2
ECONOMIC INDICATORS IN ASIA

	GDP (%annual growth)		Domestic savings/GDP (%)		Gross domestic investment/GDP (%)		Exports	
							Billions of dollars	Current annual growth (%)
	1971-1980	1981-1990	1981-1990	1992	1981-1990	1992	1992	1987-1992
Hong Kong	9.3	7.1	30.7	31.4	27.9	28.4	119.5	22.7
Korea	9.0	9.9	34.0	34.9	30.5	36.2	75.3	14.9
Singapore	7.9	6.3	42.5	47.2	42.0	40.8	60.2	19.4
Taiwan Province of China	9.3	8.5	32.9	26.7	22.6	24.4	80.9	13.1
China	7.9	10.1	33.5	40.3	34.3	39.4	68.6	18.1
Indonesia	7.7	5.5	32.0	37.7	30.4	35.7	33.4	15.1
Malaysia	7.8	5.2	33.0	33.8	30.8	35.2	37.6	18.7
Thailand	7.9	7.8	22.3	33.1	26.7	36.7	33.3	25.0
Pakistan	5.2	6.3	10.3	11.4	18.7	18.7	2.0	14.7
India	3.7	5.5	20.1	24.3	22.2	26.7	18.8	10.7

Source: Asian Development Bank, *Asian Development Outlook, 1992*, Manila, 1993.

change, introduced into dynamic economies, obviously helps to create jobs in the medium term. In the shorter term, it may produce the opposite results. Perhaps the most striking impact of the current technological cycle on employment is that, rather than eliminating jobs, it makes skills and know-how obsolete. Accordingly, some jobs disappear while others are created which require skills that differ from those of the currently unemployed or those displaced by technical or organizational change. A scenario of lower growth in the industrialized economies tends to make the short-term negative effects prevail over the longer-term dynamic potential.

The current state of the world economy is characterized by a profound process of transformation. While fiscal deficits persist in some of the major industrialized economies, it is plausible that, in the coming years, global economic growth and trade dynamism will be slower than those of the preceding decades. Nevertheless, beyond the aggregate figures, it is clear that better results are obtained by those sectors and activities which accept the technological challenge of globalization and competitiveness. This is reflected in the Asian dynamism and in the high growth of international trade in services and foreign investment.

Finally, competitiveness based on promoting and disseminating technical change and improving labour skills, with a view to coping with the globalization of the world economy, is the main challenge on the international scene. Accordingly, there is an urgent need for Latin America and the Caribbean to confront the challen-

ges of increasing quality and productivity in order to participate in the dynamic flows and zones of international trade.

2. Trends in international trade

Despite the sluggishness of world economic production and growing concern about the international trade system, in recent years the volume of trade has increased at almost the same annual rate as during the two previous decades. As shown in table I.3, trade volume grew at an average rate of 4.5% between 1990 and 1992, compared to an average of 4.8% between 1970 and 1990. Only in the 1960s was the figure strikingly higher (7.4%).

Although world trade volume has grown at a fairly constant rate, its value has fluctuated considerably. Table I.3 shows that trade value grew by around 9% annually in the 1960s, more than doubled this rate to 20% in the 1970s, but fell to 0.5% in the first half of the 1980s. Beginning in 1986, the fluctuations continued, with average growth of 12% between 1985 and 1990, but with a drop to 3% between 1990 and 1992.

In the 1970s the developing countries performed better than the nations of the Group of Seven as regards the value of exports; this trend slowed during the 1980s, but it revived in the last few years (see table I.3). Nevertheless, if the data on developing countries are disaggregated, it is apparent that their strong performance depended heavily on the Asian newly industrializing economies (NIEs) and on China. Since 1980, exports from the other developing regions (for example, Latin America and Africa) have grown reasonably in terms of volume, but slowly in terms of value. The economies in transition (Eastern Europe and the republics of the former Soviet Union) suffered a spectacular downturn in the volume and value of their trade in 1991; this situation was stabilized in 1992, although GDP has continued to fall, especially in the former Soviet Union.

The results of these variations in growth rates may be noted in the differences in regional shares of the value of world trade (see table I.4). The developed countries raised their share from 66% in 1960 to 72% in 1992, whereas the developing countries raised theirs from 22% to 24%. This latter figure is explained partly by the drop in the share of Eastern Europe and the former Soviet Union, but mainly by the good performance of Asia, whereas the Latin American share fell from 8% to 4%, and the African share from 4% to 2%.

Naturally, the difference between the growth of trade volume and that of trade value is due to the behaviour of prices. The 1970s were an exceptional period, in that the price rises increased the value of trade enormously. Except in that decade, prices generally have had a negative effect on export value for developing countries. In the 1990s, the impact has been particularly negative, since average prices have fallen more than in any other period covered by the present study.[3]

Commodities are particularly vulnerable as regards both trends and volatility of prices. Figure I.1, which covers the period 1983-1992, suggests that there has been considerable divergence among non-fuel commodity prices: they range from an annual average decline of 15% for cocoa to an increase of 9% for manganese (in constant United States dollars). Nevertheless, the decline in prices far outweighs the increases. Consequently, the efforts to raise

3 A weighted price index developed by the World Bank, which has a 1979-1981 base and includes 33 products, excluding petroleum, showed that 1986-1990 was the worst price period for commodities in the post-war period. The data for 1991-1993 indicate a downturn of 14% in that price index; 1993 was the worst year, following which a very modest recovery in prices is expected by the year 2000. In that year, according to the projection, the index should show a recovery of 12% with respect to the present level, and thus will not have regained its average level for the 1986-1990 period (Avramovic, 1992).

Table I.3
INTERNATIONAL TRADE GROWTH
(Annual average %)

	Total world	Developed countries	United States	Japan	EEC	Developing countries	Latin America	Middle East	Asia	Africa	Economies in transition
1960-1970											
Real GDP	5.2	5.1	4.4	10.3	4.7	5.8	5.5	6.2	5.1	5.4	6.7
Export volume	7.4	8.4	6.6	16.0	8.8	7.9	3.1	9.5	6.5	11.4	...
Export value	9.3	10.1	7.8	16.9	10.4	7.4	5.7	9.3	6.7	9.0	...
Import volume	8.6	9.5	9.3	14.4	8.9	5.3	4.9	6.3	6.0	4.2	...
Import value	9.2	10.3	10.2	15.4	10.1	6.7	6.3	7.4	6.9	5.3	...
1970-1980											
Real GDP	3.7	3.1	2.8	4.4	2.9	5.5	5.4	6.4	6.1	6.2	5.2
Export volume	5.1	6.4	6.2	9.7	5.0	0.4	0.4	-1.3	8.3	-2.7	6.1
Export value	20.3	18.8	18.2	20.3	19.3	25.9	20.8	34.3	25.8	21.7	14.9
Import volume	5.4	4.9	4.7	5.0	5.5	7.8	5.1	16.3	7.6	7.8	8.3
Import value	20.2	19.5	21.2	22.0	19.8	23.8	20.6	33.6	23.5	22.2	13.6
1980-1985											
Real GDP	2.0	2.4	2.9	3.9	1.5	1.9	1.3	0.5	5.3	1.0	2.1
Export volume	2.5	3.4	-0.2	7.4	1.7	-1.4	3.7	-12.3	7.4	-4.8	5.1
Export value	-0.6	0.5	-0.2	6.2	-1.1	-4.4	-0.8	-14.3	2.5	-8.3	0.5
Import volume	2.7	3.2	6.8	1.7	1.8	0.2	-5.8	0.6	4.9	-2.5	3.1
Import value	-0.4	-1.4	7.1	-1.6	-3.0	-2.6	-8.0	-2.0	2.5	-6.3	-1.3
1985-1990											
Real GDP	3.3	3.2	3.0	4.6	3.1	3.4	1.9	1.3	6.9	2.4	0.8
Export volume	6.4	5.3	8.2	2.9	9.9	8.2	3.0	7.9	12.7	2.4	-1.6
Export value	12.1	14.0	12.5	10.3	15.9	11.5	4.5	7.3	18.6	3.1	1.0
Import volume	7.1	6.5	3.7	9.9	7.6	6.4	2.1	-3.5	13.5	0.0	0.6
Import value	12.0	14.6	7.4	12.6	16.1	13.4	7.5	2.9	19.0	5.3	3.5
1990-1992											
Real GDP	0.4	1.6	0.5	3.1	1.3	4.2	2.6	3.3	5.1	1.7	-12.9
Export volume	4.5	3.5	6.5	1.0	2.5	7.6	8.5	-1.7	13.0	1.6	-26.5
Export value	3.2	3.7	6.7	9.0	2.9	7.0	1.4	-5.0	10.2	-4.2	-12.1
Import volume	4.7	3.1	4.0	0.8	4.0	11.5	18.5	9.7	12.6	2.6	-27.3
Import value	2.5	2.0	1.8	-0.3	3.8	11.1	15.6	5.7	12.6	0.5	-14.3

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1988* (TD/STAT.16), New York, 1989. United Nations publication, Sales No. E/F.88.II.D.11; and *Handbook of International Trade and Development Statistics, 1991* (TD/STAT.19), New York, 1992. United Nations publication, Sales No. E/F.92.II.D.6. United Nations, *World Economic Survey, 1992* (E/1992/40; ST/ESA/231), New York, United Nations publication, Sales No. E.92.II.C.1; *World Economic Survey, 1993* (E/1993/60; ST/ESA/237), New York, United Nations publication, Sales No. E.93.II.C.1; and *Monthly Bulletin of Statistics*, various issues, New York.

the volume of exports have been offset by the behaviour of prices.

The situation of prices for mineral products was very negative in the past decade. As indicated in figure I.1, most mineral prices tended to fall because demand fell as technological changes led to the use of smaller quantities of raw materials per unit of production. Consequently, minerals and metals significantly reduced their share in world exports. However, in absolute terms, the sector continues to attract new investments, and new mines are opening up. Those countries with high-grade minerals and low production costs can benefit from this situation; for others, the price levels will make them uncompetitive (see box I.1. for more details).

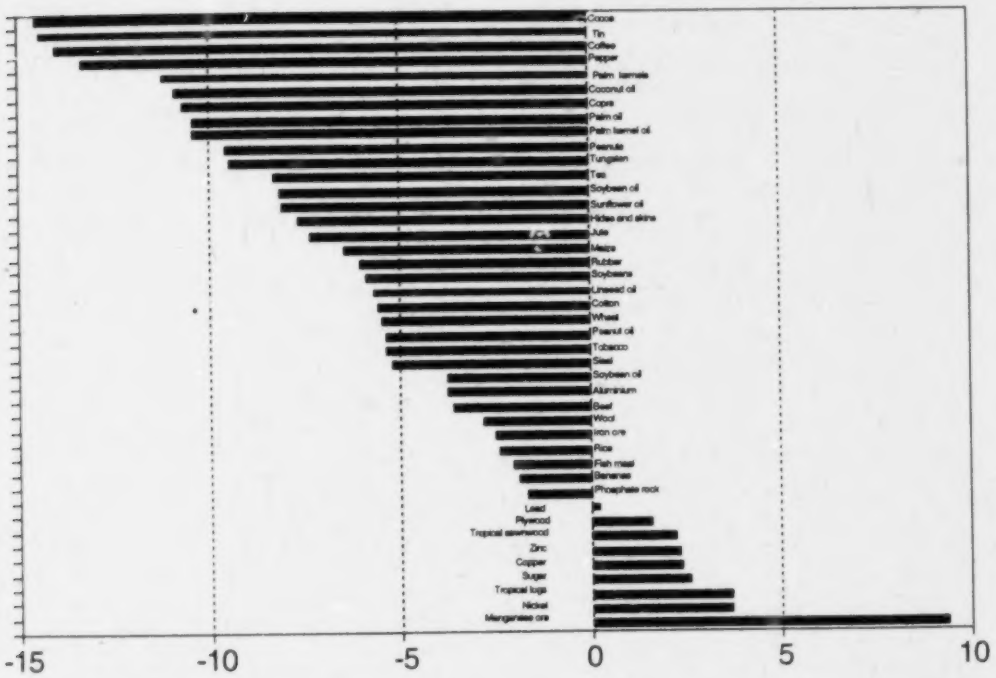
Table I.4
SHARE IN WORLD TRADE
(Percentage in current dollars)

	Exports						Imports					
	1960	1970	1980	1985	1990[a]	1992	1960	1970	1980	1985	1990[a]	1992
World	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Developed countries	65.9	70.9	62.6	66.2	71.4	71.5	64.9	71.6	68.3	64.8	72.3	70.1
Group of Seven	48.9	52.7	46.3	34.7	52.8	51.6	41.9	44.8	43.1	46.3	54.9	53.3
United States	15.8	70.1	11.0	11.3	11.5	12.0	11.1	12.2	12.5	17.9	14.6	14.3
Japan	3.1	6.1	6.5	9.1	8.4	9.1	3.3	5.8	6.8	6.4	6.6	6.0
European Community	32.2	35.5	32.5	31.7	36.8	35.7	32.7	35.3	34.6	30.3	35.7	35.0
Economies in transition (FOB)	10.1	9.8	7.7	6.7	5.1	4.7	10.2	9.7	7.7	8.3	5.5	3.4
Developing countries	21.9	18.4	28.7	23.6	21.6	23.9	22.6	17.9	22.9	20.5	20.4	23.4
Latin America and the Caribbean	7.7	5.5	5.5	5.4	3.9	3.7	7.3	5.5	5.9	4.0	3.2	4.1
LAIA	5.6	4.0	4.0	4.4	3.3	3.2	5.0	3.5	4.1	2.5	2.3	3.2
CACM	0.3	0.4	0.2	0.2	0.1	0.1	0.4	0.4	0.3	0.3	0.2	0.2
Caribbean countries	0.5	0.4	0.5	0.3	0.2	...	0.6	0.6	0.7	0.4	0.2	...
Asia[b]	9.5	8.1	17.8	14.3	15.2	16.0	9.7	7.8	12.3	13.1	14.3	16.6
Newly industrializing economies (NIEs)	3.4	3.0	6.0	8.0	10.1	11.5	3.6	3.8	5.8	6.9	9.9	11.3
China	2.0	0.7	0.9	1.4	1.8	2.2	1.9	0.7	0.9	2.1	1.5	2.0
India	1.0	0.6	0.4	0.5	0.5	0.5	1.7	0.6	0.7	0.8	0.7	0.6
Africa	4.2	4.1	4.7	3.2	2.0	1.8	4.9	3.4	3.6	2.7	2.1	2.1
Oil-exporting countries[c]	6.8	6.3	16.4	8.8	6.0	5.8	4.8	3.5	7.0	5.6	3.5	4.2
Non-oil-exporting countries[c]	15.1	12.1	12.3	14.8	15.6	17.3	17.9	14.4	15.9	14.8	16.9	18.6

Source: UNCTAD, *Handbook of International Trade and Development Statistics, 1991* (TD/STAT.19), New York, 1992. United Nations publication, Sales No. E/F.92.II.D.6.
United Nations, *World Economic Survey, 1993* (E/1993/60; ST/ESA/237), New York. United Nations publication, Sales No. E.93.II.C.1.
International Monetary Fund (IMF), *Direction of Trade Statistics Yearbook*, Washington, D.C., 1993.
European Communities, Project LINK, *Short and Medium-Term Development Prospects in the Asia-Pacific Region*, September 1993.

[a] 1990 and 1992, updated with United Nations, *Monthly Bulletin of Statistics*, July 1993. [b] Developing Asia, except for China in 1990 and 1992. [c] ECLAC estimates.

Figure I.1
TRENDS IN THE MARKET PRICES OF THE MAIN NON-FUEL COMMODITIES, 1983-1992
(Annual average growth rate, in constants dollars)



Source: United Nations Conference on Trade and Development (UNCTAD), *Commodity Yearbook, 1993*, table A.2, New York, 1993.

The experience of the agricultural and forestry sectors has been more diverse than that of the mining sector. In the former, the largest trade volume has traditionally been in cereals, which saw a general decline in their growth rate during the 1980s. This trend coincided with greater self-sufficiency in the large countries, including India and China. Similar trends are apparent in other traditional export crops. At least two phenomena have contributed to these problems. One of them is the low income elasticity of traditional foodstuffs. The other has to do with the substantial intervention by industrialized nations in agricultural markets in response to internal political pressures.

Non-traditional products have evolved much more favourably. For example, world fruit imports have grown rapidly in the industrial countries, where meat and carbohydrates now account for

Box I.1

WORLD MINERAL MARKET

Owing to the effects of substitution and miniaturization, the growth of the world economy is no longer producing an increase in metal consumption. Substitution results in changes in relative prices with the appearance of new materials, while miniaturization reduces demand for metallic inputs per unit of manufactured output, the automobile being the best illustration. Financial globalization, in turn, accentuates the role of financial variables in inventory accumulation, which increases the volatility of international prices.

The slower growth of world consumption of leading metals contrasts with the striking dynamism which has marked consumption in the Asian NIEs. In the 1980s, the consumption of primary aluminium in the Republic of Korea grew by an average rate of 18%, refined zinc by 13% and refined copper by 12%; in the Taiwan Province of China, the growth rates were 8%, 7% and 12%, respectively.

The world's mineral supply was decentralized in the last two decades, owing to a greater government role as a result of nationalizations, and to increases in the degree of processing and in smelting and refining capacity. Environmental constraints foster the opening of new deposits in developing countries and promote a relocation of smelting and refining capacities.

Minerals and metals reduced their share in world exports from 7% at the beginning of the 1970s to 4% at the end of the 1980s. In 1985 dollars, however, mineral and metal exports more than doubled in the last two decades, generating a market on the order of US$ 84 billion per year. Mineral and metal exports are less dynamic than those of manufactures; in absolute terms, however, they form a very large market which continues to stimulate the exploitation of new deposits. Current trends point towards a restructuring of supply through ever-decreasing margins between prices and production costs. Significant changes can be expected in decisions about the opening of new mines, with preference for those having large deposits, low infrastructure costs and, of course higher-grade minerals. Accordingly, the principal mining districts of the region which meet such requirements will continue to receive large flows of foreign investment in expansions or new mines.

SHARE OF MINERALS AND METALS IN WORLD TRADE

(% of world totals)

	EXPORTS		IMPORTS	
	1970	1990	1970	1990
Developed countries	59	67	85	76
Developing countries	32	25	7	18
Latin America	14	12	2	2
NIEs	1	2	1	7
Economies in transition	9	8	8	4

TRENDS IN WORLD CONSUMPTION OF MAJOR METALS

(% of annual average growth)

	1960	1970	1980
Refined aluminium	9.0	4.4	1.5
Refined copper	4.3	2.6	1.4
Refined tin	1.0	1.0	1.0
Refined zinc	5.0	2.2	1.3
Iron ore	4.0	2.0	0.5
Nickel	6.0	2.0	2.0
Refined lead	4.0	3.0	1.0

In recent years, metal prices have shown a clear downward trend. Between 1983 and 1992, for example, tin prices fell by an average rate of 14%, and iron and aluminium prices dropped at rates of 3% and 4%, respectively. At the same time, lead, zinc and copper prices rose, although at rates of less than 3%.

Source: United Nations Conference on Trade and Development (UNCTAD), *Commodity Yearbook, 1993*, New York, 1993, *Metal Statistics, 1960-1970* and *Metal Statistics, 1962-1972*, New York, American Metal Market/Fairchild Publications, and *World Metal Statistics Yearbook*, Ware, Hertford, United Kingdom, World Bureau of Metal Statistics, 1984, 1990 and 1993 editions.

a lower share of the average diet. Similarly, imports of forestry products increased when ecology groups focused their attention on maintaining native forests (see box I.2 and chapter II, section 5).

In addition to the trends of falling demand and prices, the latter continue to show their traditionally high volatility. If the 17 commodities which appear in the *Economic Survey of Latin America and the Caribbean* are taken as a sample, the annual average price variation between 1980 and 1993 ranged from 5.5% for frozen beef to 37.6% for raw sugar; tin was situated in the middle with a price variation of 14.3%. These figures for specific products compare with an annual average variation of 7.2% for an index of 34 commodities (excluding petroleum) and of 6.1% for an index of manufactured goods (see table I.5). The lower volatility of the commodity index, compared to individual primary products, suggests the utility of diversification, even among commodities themselves. Apart from diversification, producers have sought other ways of dealing with price volatility. Previously, these methods involved establishing buffer stocks and forming cartels; more recently, however, such efforts have centred on futures markets (see evaluation in chapter II, section 3).

Box I.2

FOOD CONSUMPTION PREFERENCES IN THE DEVELOPED COUNTRIES

In the past three decades, average per capita income in the industrialized countries doubled. According to World Bank figures, per capita GDP in high-income countries —in constant 1990 dollars— rose from US$ 10,800 to US$ 19,550 between 1965 and 1990. This rise in living standards has been accompanied by changes in both the composition and the characteristics of families residing in the richest parts of the world. According to a recent study on Europe,[a] among the changes observed as a result of higher incomes are trends towards forming households with fewer members[b] and increased participation by women in the labour force.

In addition to this structural recomposition of households, there has been a change in consumption preferences: foods are healthful, balanced, dietetic, natural and, moreover, diversified and easy to prepare. Thus, the demand for food products available in individual ready-to-serve portions has increased. This has led to the substitution of processed foods for fresh products, higher consumption of tropical fruits and vegetables out of season and the development of food-marketing chains. At the same time, easily prepared vegetables such as tomatoes and avocadoes, and substitute products such as frozen or canned vegetables and ready-to-eat meals, have appeared more often in the markets.

This has opened up possibilities for Latin America to sell new items in industrialized countries. The figure below shows what can be called a "life cycle" for some export fruits. In their first years on the market, these products generally enjoy rapid increases in demand; they then tend to decline. The length of the cycle depends on factors as diverse as the degree of replacement of the product (either by different products or new varieties), the volume of supply, the marketing structure, the status of aggregate demand and more cyclical factors, such as current fashion.

At present many fruits and vegetables that are non-traditional exports for Latin America seem to be in the first stages of the cycle in the industrialized countries, that is, in the stages of introduction and experimentation. Other products, especially those characteristic of temperate climates, could more likely be at the end of the cycle. Nevertheless, it should be kept in mind that the incorporation of several new countries into agricultural exporting has prompted increased competition and therefore shortened the life cycles of these products (a typical example being the kiwi).

Source: ECLAC, La apertura y los procesos agroexportadores (LC/R.1299), Santiago, Chile, ECLAC, Division of Production, Productivity and Management, 1993.

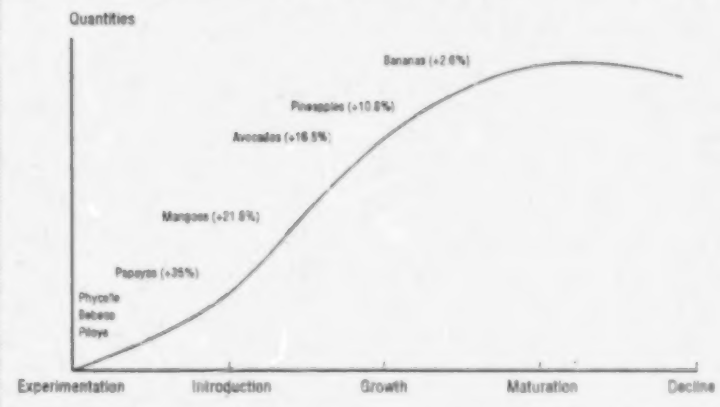
[a] Commission of the European Communities, *Estudios del mercado de la CCE para frutas, cítricos y hortalizas*, Brussels, 1991.

[b] It is estimated that one third of the households in some European cities now consist of only one person.

Box I.2 (concl.)

GROWTH OF EUROPEAN DEMAND FOR CERTAIN TROPICAL FRUITS

(Average growth rate 1976-1988)



Source: European Economic Community, *Estudios del mercado de la CEE para frutas, cítricos y hortalizas*, vol. 2, Brussels, Commission of the European Communities, 1991.

Table I.5

VOLATILITY OF EXPORT PRICES, 1980-1993

(Annual average variation)

Product	Percentage[g]
Raw sugar[a]	37.6
Bananas[a]	13.7
Cocoa[a]	12.5
Coffee (mild)[a]	19.6
Beef[a]	5.5
Fish meal[b]	19.6
Maize[b]	14.4
Soya[b]	9.7
Wheat[b]	10.2
Cotton[a]	15.7
Wool[a]	9.6
Copper[a]	13.4
Tin[c]	14.3
Iron ore[b]	9.1
Lead[a]	17.9
Zinc[a]	17.1
Petroleum[d]	21.3
Primary products index[e]	7.2
Manufactured products index[f]	6.1

Source: UNCTAD, *Monthly Commodity Price Bulletin*, Supplement 1970-1989, Geneva, November 1989 and *Monthly Commodity Price Bulletin*, vol. 13, No. 9, Geneva, September 1993; Petroleum Intelligence Group, *Petroleum Market Intelligence*, New York, International Monetary Fund (IMF), *International Financial Statistics, Yearbook*, Washington, D.C., 1993; United Nations, *World Economic Survey, 1993* (E/1993/60; ST/ESA/237), New York, United Nations publication, Sales No. E.93.II.C.1; and *Monthly Bulletin of Statistics*, New York, June 1986.

[a] Cents per pound. [b] Dollars per metric ton. [c] Dollars per pound. [d] International Monetary Fund index.
[e] Index of 34 products (excluding petroleum) of the IMF. [f] United Nations index of the unit value of manufactured products (SITC 5-8). [g] Percentage for 1993 is for January-August for individual products; the indices are up to December 1992.

Table I.6
STRUCTURE OF EXPORTS BY GROUPS OF COUNTRIES
(Percentages)

	1962	1970	1980	1990	1992[a]
Total world[b]	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Food	21.4	15.6	15.3	11.1	9.5
Non-food agriculture	10.2	6.4	5.9	3.9	2.1
Metals and minerals	7.7	8.2	6.1	5.2	2.4
Fuels	11.4	9.9	10.8	24.5	4.3
Manufactures[c]	49.2	59.9	61.9	54.0	81.6
Total G-7[b]	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Food	13.0	9.9	10.5	10.1	7.9
Non-food agriculture	5.1	3.6	3.6	3.0	2.1
Metals and minerals	5.4	5.5	3.9	4.5	2.4
Fuels	4.2	3.2	3.1	5.5	2.8
Manufactures[c]	72.2	77.7	78.8	77.0	84.8
Total EEC[b]	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Food	11.6	10.8	10.9	10.3	11.1
Non-food agriculture	3.5	2.5	1.9	1.6	1.6
Metals and minerals	3.9	4.3	3.9	2.7	2.3
Fuels	5.2	3.8	8.2	3.7	3.3
Manufactures[c]	75.7	78.6	75.1	81.7	81.8
Total United States of America[b]	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Food	21.2	16.6	18.7	11.6	11.4
Non-food agriculture	6.4	5.1	5.2	4.6	3.8
Metals and minerals	4.1	5.4	5.2	3.2	2.4
Fuels	3.8	3.9	3.8	3.4	2.7
Manufactures[c]	64.5	69.1	67.0	77.2	79.6
Total developing countries[b]	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Food	37.3	29.3	15.5	13.1	12.1
Non-food agriculture	19.0	11.6	5.3	3.5	2.4
Metals and minerals	10.0	14.3	6.4	4.5	3.3
Fuels	19.4	18.9	38.8	13.4	9.7
Manufactures[c]	14.6	25.9	30.7	65.5	72.5
Total Latin America and the Caribbean[b]	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Food	40.3	40.7	27.9	24.9	27.2
Non-food agriculture	12.2	6.6	3.5	3.6	2.9
Metals and minerals	13.2	18.3	10.4	11.7	7.8
Fuels	29.1	23.0	40.8	26.7	14.4
Manufactures[c]	5.2	11.5	17.4	33.1	47.6
Total newly industrializing economies[b]	**100.0**	**100.0**	**100.0**	**100.0**	**100.0**
Food	20.1	15.4	10.4	7.3	11.1
Non-food agriculture	35.0	21.1	9.5	3.4	1.6
Metals and minerals	9.2	7.9	3.7	1.5	2.3
Fuels	11.3	9.3	22.0	9.4	3.3
Manufactures[c]	24.4	46.3	54.4	78.3	81.8

Source: ECLAC, International Trade, Finance and Transport Division.
[a] Estimates. [b] The total excludes section 9 of SITC. [c] Manufactures include sections 5 to 8 of SITC, except chapter 68.

Another way of handling the volatility arising from the problems of export prices has been to shift from commodities to manufactured products. Table I.6 shows that, during the last three decades, the importance of commodities in world trade fell and that of manufactures increased. This trend is seen in developed and developing countries alike. It is particularly apparent in Latin America, given the low level of manufactured exports from the region at the beginning of the 1960s. Although this level has increased considerably, only 48% of Latin American exports consisted of manufactured goods in 1992, compared to 85% for the Group of Seven and 82% for the Asian NIEs. Naturally, this means that there is plenty of room for the region to upgrade its export basket.

The concept of upgrading export quality is linked to the relative dynamism of the markets for different products. This dynamism, in turn, is related to the current technological revolution, which has brought about a significant change in the relative importance of products and producing nations. Although they function unevenly across sectors, the new technologies are cutting down on the use (per product unit) of energy, raw materials, time, capital and manpower, thus eroding the strategies of specialization based on low world prices of those factors.

During the 1980s, for example, knowledge-intensive products saw their demand rising at annual rates of over 9%; natural resource-intensive products grew below the average (5.7% per year).[4] The greatest dynamism was found in the services and manufacturing sectors and, among the latter, the highest growth was in electronic goods.[5]

At the same time there was dynamic growth in some natural resource-based products, such as fish preparations, paper, furniture, wooden manufactures, toys and fruit preparations. In the medium term, however, the growth of natural resource-intensive exports will tend to reach a limit imposed by technological change and by lower income elasticities of demand. Moreover, possible trade barriers based on environmental considerations tend to affect those products in particular. (On the effect of the new emphasis on the environment, see chapter II, section 5.)

In terms of specialization, product "quality" is not only a market concern. Specializing in "low-quality" products, with markedly cyclical prices, may increase external vulnerability and the probability of macroeconomic imbalances. By relying excessively on primary products with a low level of processing, taking advantage of low wages or an unregulated labour market, labour and environmental conditions are adversely affected and the country's achievement of systemic competitiveness is undermined.

Competitive advantages today depend on high-quality services, which incorporate design, know-how and technology. Behind a product traded in international markets is a chain of activities of a high value-added —research, design, engineering, complex manufacturing, management and marketing strategy— and others of lower value-added, such as storage, low-skill assembly and unprocessed natural resources. To strengthen the competitiveness of the region, the productive and human resources base must be improved in order to stimulate these chains of activities.

None the less, a simplistic dichotomy should not be set up between commodities and manufactures, whereby the features of quality and export dynamism would be assigned exclusively to the latter. There are cases of recent industrialization where it has been possible to reconcile the dynamic export of manufactured goods with

4 Information based on figures published in GATT (1990a), for the period 1979-1988.

5 In 1973, commodities accounted for 38% of the world's merchandise trade, including fuels. Manufactures accounted for 60% of world trade. In 1990, the respective shares were 27% and 70%. At present, trade in services amounts to about 20% of the world's trade in goods. Between 1970 and 1990, international trade in services grew at annual rates of 13% (Rosales, 1990).

the development of an agro-industrial complex that exports high-quality products.[6] In Latin America also, there are cases of diversification and high export dynamism among non-traditional products in the agriculture, fishing and forestry sectors, which blurs the presumed dichotomy. What is clear is the need to incorporate more knowledge into natural resource products, strengthening backward and forward linkages with manufactured products and services and improving the variety, marketing, presentation, promotion and quality of the product.

6 In the 1980s, for example, Thailand's exports of canned fish and shrimps grew at annual rates of 29% and wood products at 21%. Malaysia saw growth rates of 33% in exports of manufactures based on rubber and 10% in wood products (ECLAC, 1992b).

Chapter II

THE INTERNATIONAL ECONOMIC ORDER

1. Trade rules and the GATT negotiations

The most prominent aspect of the international trade environment is the recently approved Final Act of the Uruguay Round negotiations on new trade rules. In principle, there is virtual consensus —on the part of developed and developing countries alike— on the need for new rules governing key aspects of international trade. This consensus is based on estimates that the successful conclusion of the Uruguay Round will increase international trade by some US$ 200 billion annually by the year 2002.[7] Increased trade, in turn, is expected to pull the developed countries out of the lingering recession that virtually all of them have been experiencing. On the negative side, it is feared that, despite the aforementioned successful conclusion, protectionist sentiments are still strong, especially in industrialized countries.

The Uruguay Round was much more ambitious than previous rounds of negotiations on the General Agreement on Tariffs and Trade (GATT). In addition to traditional negotiations on lowering tariff barriers, many new topics were discussed. Some related to the inclusion of categories that had previously been excluded from GATT rules, such as services, agriculture and textiles. Others concerned areas that required more rigorous agreements, such as those on safeguards, to avoid or replace the use of "grey area" measures (e.g., voluntary export restraints). Even more unusual was the consideration of some topics, such as intellectual property or investment rules, that are not strictly trade-related.

The inclusion of these new topics on the agenda of the negotiations tends to blur the borderline of the list of regulations that should be discussed in the context of trade talks. Today, trade negotiators are also scrutinizing labour and environmental conditions and have coined expressions, such as "labour dumping" or "social dumping", whose meaning is highly debatable.

To understand the nature of the new topics, it must be recalled that GATT negotiations before the initiation of the Uruguay Round had dealt with the growing liberalization of merchandise trade under multilateral, non-discriminatory principles based on the use of tariffs. In addition, efforts were made to replace non-tariff barriers with tariffs calculated to have an equivalent effect. The aim was to reduce and eliminate, through a process of multilateral negotiation, all trade barriers at national borders. Currently, however, the

7 Cited at a press conference by Peter Sutherland, Director-General of GATT, 26 September 1993. The figure is based on Goldin, Knudsen and van der Mensbrugghe (1993).

world economic situation is shifting the focus of the negotiations. The ongoing technological revolution is helping in various ways to increase the economic interdependence of nations. The rapid expansion of informatics and telematics has opened up a large and extremely dynamic market in the area of services. International trade in these types of services requires direct investments in building their infrastructure. Consequently, investments related to trade and services became a subject for negotiation under GATT, on the basis of principles such as the right of establishment and the national or non-discriminatory treatment of foreign direct investment. The negotiations in this round were therefore extended to legal regimes whose adoption had traditionally been the prerogative of the individual countries.

From the viewpoint of developing countries, the Final Act of the Uruguay Round produced a number of positive results which, however, fell short of initial expectations. First, the tariff barriers imposed on industrial goods were cut by over 30%, although they were already low in general. Most important, however, is the progressive elimination, over a 10-year period, of quotas under the Multifibre Arrangement and the reduction of the corresponding tariffs; these barriers to textile and clothing imports in the developed countries were among the most damaging for incipient exporters of industrial products in developing countries. Second, agricultural subsidies and import barriers will be reduced over a six-year period. National agricultural subsidies will be cut by 20%, while subsidized exports are to decline by 36% in value and 21% in volume. All import barriers will be replaced by tariffs and lowered by some 36%. Since these subsidies have been used to a lesser degree in developing countries, their reduction in the industrialized world should broaden trade opportunities for efficient developing-country producers. Third, antidumping measures will be made more transparent, thus limiting a country's ability to use them as a threat to its trading partners. Also, the dispute settlement system was made more automatic and the power to adopt unilateral measures was reduced. Since such measures have most often been applied by industrialized countries in the past, the limits placed on their use should benefit the developing nations.[8]

At the same time, some developing countries are concerned about the possible negative effects of the Final Act. For example, some Governments feel that the developing countries have lowered their tariffs much more than their industrialized trading partners (*Financial Times*, 16 December 1993). The relatively less developed countries, especially the ones that import food, are worried that higher food prices will hurt their economies (Goldin, Knudsen and van der Mensbrugghe, 1993). Some Latin American experts fear that the provisions of the Final Act will limit the region's capacity to promote its exports in the future. For example, although the Act recognizes that developing countries have special needs and should be exempt from certain obligations, it eliminates many of the special-treatment measures granted previously, except those applied to least developed nations. Moreover, unlike the Tokyo Round, the Uruguay Round does not allow developing countries the option of not accepting provisions they consider potentially unfavourable. The rules on intellectual property are a particular cause of concern, since they may raise the prices of medicines and other patented products in the short term, but may also limit access to new technologies in the longer term (Agosin and Tussie, 1993).

Beyond these generalizations, it is difficult to analyse the consequences of the Final Act for developing countries as a whole. In addition, a striking feature of the negotiation process was the formation of a new set of coalitions that broke from the

8 An extremely favourable view of the Final Act, from the perspective of the developing countries, appears in GATT (1993a).

traditional alignment of developed countries versus developing ones. For example, the Cairns Group comprised five Latin American countries and several countries in the developed world. The impact may also vary from one country to another, benefiting some and hurting others. It will be crucial for both the Governments and the private sector of the developing countries to analyse the provisions in detail to identify any new opportunities they offer. In relation to the Final Act's main provisions on the treatment of developing countries, see box II.1.

The main benefit of the GATT negotiations probably lies in the fact that they dealt a strategic blow to protectionist postures. This explains why they have had a favourable impact on the expectations of the world economic community, and have been welcomed, despite their limitations, by the developing countries in general and those of the region in particular.

Indeed, an updated set of multilateral rules on trade in goods and services, though imperfect as yet, can yield net benefits for the developing countries in a context of globalization. Conversely, the lack of such rules could lead to conflicts between trading blocs or the unilateral domination of the major trading powers.

2. Special trade regimes

The GATT rules on open multilateral trade based on the most-favoured-nation principle include a number of exceptions; one of these relates to the preferential trade regimes established by the developed countries, based on the internationally accepted principle of favouring developing nations. The most important of these regimes is the Generalized System of Preferences (GSP), which is supported by all the industrialized countries. In addition, some individual countries grant preferences of their own.

a) Generalized System of Preferences

In 1971 a large group of industrialized nations granted preferential tariff treatment to manufactures imported from developing countries. The aim was to stimulate the diversification of production in those countries and to incorporate them into the world manufactures trade. Although more than 20 developed countries grant preferences under this system, some 90% of all GSP imports to the countries of the Organisation for Economic Cooperation and Development (OECD) go to the United States, the European Community and Japan.

To give an idea of the quantitative importance of the GSP, an "effective impact" index can be defined. This index shows the ratio of the value of goods imported under the GSP to the value of total imports from the country or region benefited. It thereby indicates the effective impact of the GSP on total exports from the beneficiary to the country that grants the preference.

Table II.1 summarizes the benefits thus received by the developing countries in general and the Latin American countries in particular. The degree of effective impact is very similar for the two groups: 15.4% and 15.6%, respectively. For Latin America, the preferences granted by Japan and the European Community have a greater effective impact than those of the United States. However, the absolute value of the exports covered is higher for the United States, since that country imports more Latin American products.

The index reflecting the impact of the GSP may be low for various reasons. On the one hand, many products may be excluded because they enjoy duty-free entry under other systems of exceptions or another general regime (e.g., certain minerals) or because of political pressure exerted by producers in the countries granting the preference (e.g., textiles). On the other hand, use of the benefit may be limited, possibly owing to a lack of awareness of the GSP on the part of Governments and entrepreneurs. Another problem is that the countries that grant preferences impose quotas and other barriers to their use. Moreover, they may suspend the benefit for reasons such as the competitive need clause, invoked in some cases by the

Box II.1

URUGUAY ROUND: TREATMENT OF DEVELOPING COUNTRIES

The provisions on this topic contained in the draft Final Act can be summarized as follows:

1) Time-limited exceptions and longer periods for implementing obligations.
   a. Trade-related aspects of intellectual property rights, including trade in counterfeit goods: compliance with obligations in this matter may be delayed for a further period of four years for developing countries and 10 years for least developed countries.
   b. Technical barriers to trade: specified and time-limited exceptions in whole or in part from the obligations under the relevant agreement may be granted to developing countries.
   c. Import licensing procedures: developing countries may delay the application of provisions relating to automatic import licensing by not more than two years from the date of entry into force of the relevant agreement.
   d. Subsidies and countervailing measures: the prohibition against the granting or maintenance of export subsidies will not apply to the least developed countries. For other developing countries, the phase-out period for export subsidies will be within eight years from the entry into force of the relevant agreement, and two years in the case of reaching export competitiveness in any given product (criteria defining export competitiveness are formulated).
   e. Implementation of article VII on customs valuation: developing countries may delay application of its provisions for up to five years.
   f. Agriculture: the least developed countries are exempted from making reduction commitments; other developing countries will have the flexibility to implement their reduction commitments over a period of 10 years.
   g. Sanitary and phytosanitary measures: longer time-frames for compliance with these measures are granted to developing countries. Specified, time-limited exceptions in whole or in part from the obligations of the relevant decision may also be granted, upon request, to developing countries. The least developed countries are granted even more flexible time-frames and conditions.
   h. Safeguards: developing countries will have the right to extend the period of application of a safeguard measure for up to two years beyond the maximum period of eight years.
   i. Trade-related investment measures (TRIMs): developing countries may deviate temporarily from a general provision, and a longer time-frame of five years is provided for developing countries to eliminate TRIMs that are inconsistent with the relevant provisions, this period being extendable upon request. A time-frame of seven years is provided for the least developed countries, which is also extendable.

2) More favourable thresholds for certain commitments.
   a. Subsidies and countervailing measures: a more flexible application of remedies against subsidization involving products from developing countries is envisaged.
   b. Agriculture: there will be lower rates of tariff and subsidy reduction for developing countries, provided that the result is no less than two thirds of that specified for developed countries.
   c. Safeguard measures will not be applied against a product originating in a developing country as long as its share of imports of the product concerned does not exceed 3%, provided that developing countries with less than a 3% import share collectively account for not more than 9% of total imports of the product concerned.
   d. Textiles and clothing: small developing suppliers will be accorded differential and more favourable treatment.

3) "Best endeavour clauses", aimed at making a special effort to interpret and favour the interests and rights of the developing countries.
   a. Intellectual property rights: developed countries will provide incentives for the purpose of promoting technology transfer to the least developed countries.

Box II.1 (conclusion)

b. Anti-dumping agreement: developed countries must take a more tolerant attitude and explore alternative solutions in order not to affect the essential interests of developing countries.

c. Non-automatic import licensing procedures: special consideration should be given to importers of products originating in developing countries and, in particular, in the least developed countries.

d. Subsidies and countervailing measures: the relevant committee will seek to ensure that countervailing measures are in conformity with the needs of developing countries.

e. Agriculture: developed countries will offer improved opportunities and terms of access to their markets for agricultural products of particular interest to the developing countries, including special treatment for tropical products and products that can be substituted for illicit narcotic drug crops. Measures will also be adopted to ensure that the implementation of the results of the Uruguay Round on trade in agriculture does not adversely affect the availability of food aid, especially for the least developed countries.

4) Flexibility in procedures.

a. Balance of payments: consultation procedures may be simplified, to make them more expeditious, in the case of developing countries.

b. Settlement of disputes: there is a wide range of provisions on differential and more favourable treatment of developing countries. They provide, *inter alia*, that where one or more of the parties involved in a dispute is a developing country, the panel's report will explicitly indicate the form in which account has been taken of relevant provisions on differential and more favourable treatment. If the case is brought by a developing country, the provisions adopted will take into account not only the trade coverage of measures complained of, but also their impact on the economy of the developing country concerned. In all dispute settlement procedures involving a least developed country, the developed contracting parties will exercise due restraint in asking for compensation or suspending the application of concessions. Before initiating the regular procedures envisaged in the draft agreement, the Director-General will, upon request by a least developed contracting party, offer his good offices, conciliation and mediation with a view to avoiding a request that a panel be established. In addition, provision of legal advice to developing contracting parties and the organization of special training courses concerning GATT dispute settlement procedures and practices are envisaged.

c. Functioning of the GATT system: longer intervals of trade policy reviews for developing countries are envisaged.

5) Provisions on technical assistance.

a. Technical assistance for developing countries is envisaged in areas such as pre-shipment inspection, technical barriers to trade, sanitary and phytosanitary measures and dispute settlement.

Source: Prepared on the basis of UNCTAD, Developments and Issues in the Uruguay Round of Particular Concern to Developing Countries. Note by the UNCTAD secretariat (TD/B/39(2)/CRP 1), Geneva, 15 March 1993.

Table II.1
IMPACT OF GENERALIZED SYSTEM OF PREFERENCES, 1991
(Billions of dollars and percentage)

Preference-giving country/ region	(1) Total imports		(2) Imports under the GSP		(3) = (2)/(1) Effective impact	
	Developing countries	Latin American countries	Developing countries	Latin American countries	Developing countries	Latin American countries
United States of America	96	59	13.7	7.6	14.2%	12.9%
European Community	157	32	30.2	6.2	19.2%	19.4%
Japan	111	9	12.1	1.8	10.9%	20.0%
Total	**364**	**100**	**56.0**	**15.6**	**15.4%**	**15.6%**

Source: UNCTAD, Trade and Development Board, Replies received from preference-giving countries: European Economic Community (EEC). Note by the UNCTAD secretariat (TD/B/C.5/PREF/56), New York, April 1993; Replies received from preference-giving countries: Japan. Note by the UNCTAD secretariat (TD/B/C.5/PREF/52), New York, October 1993; Replies received from preference-giving countries: United States of America. Note by the UNCTAD secretariat (TD/B/C.5/PREF/55), New York, November 1992.

United States. They have also suspended benefits for non-economic reasons, as a kind of sanction against certain beneficiaries for alleged human or labour rights violations.

The United States "graduates" countries from the system, excluding them from GSP benefits when their per capita gross national product exceeds a certain amount, which in 1990 was US$ 10,463. The provisions also stipulate that a country will automatically lose its GSP entitlement for a given product (eight-digit tariff item) if its share of United States imports within that product category exceeds certain pre-set limits and no exception has been granted. In 1990, the general limits were 50% of total imports of a product and US$ 93 million. Countries that were already considered sufficiently competitive in 1986 are subject to tighter limits of 25% and US$ 36 million (GATT, 1992a). Also since 1990, the rules of origin for products imported from the beneficiary countries have been applied more rigorously. Recently, the United States Government requested an extension of the GSP for one year while it considers more thoroughgoing reforms of the system's operation.

Japan, for its part, applies the GSP to all developing countries, without exception. It adopted the GSP in 1971 and enacted 10-year renewals in 1981 and 1991. The system covers most industrial products (except crude oil, some textiles, countervened wood, leather garments and footwear) and about half of all dutiable agricultural products. However, ceilings are placed on imports of many industrial products entitled to GSP treatment. The system is revised every year, and recently its coverage was broadened in terms of both products and beneficiaries. Among the developing countries, the least developed countries receive special treatment, since their duty-free products are not subject to quotas. Of all of Japan's imports entitled to GSP treatment, over half come from the Taiwan Province of China, the Republic of Korea and China. With the addition of imports from the Philippines, Indonesia, Malaysia, Singapore and Thailand, this proportion rises to 72%. Brazil and Venezuela are the main Latin American

beneficiaries, with about 7% and 2% of the total, respectively (GATT, 1992b).

The European Community's GSP also dates back to 1971, and was renewed in 1981. In 1990 it was renewed for another 10 years, but will be adapted to the results of the Uruguay Round of GATT. Like Japan and the United States, the European Community applies ceilings and quotas in respect of this benefit, as well as a system of graduations according to the degree of competitiveness attained by potential beneficiaries or as a reprisal for restrictive measures implemented by the other party. Agricultural products exported from relatively less developed countries and included in the GSP enjoy free access to the European market.

b) Other preferences

The United States has other kinds of preferences in addition to the GSP. One of these, which applies to the maquila, grants preferential treatment to re-imported articles which have increased in value or been improved in quality abroad. Tariffs are imposed not on the total value of the product, but rather on the value added outside the United States.

These types of concessions relative to subcontracting or maquila regimes have become extremely important. They apply to over 15% of United States imports and have grown very quickly. About 50% of the country's imports from Mexico come under this regime, which is much more important to Mexico than the GSP granted by the United States.[9] This regime is also very important for some Caribbean and Central American countries (see chapter V, section 3).

The Caribbean Basin Economic Recovery Act applies to the five members of the Central American Common Market, the 13 members of the Caribbean Community, the Netherlands Antilles, Aruba, Haiti, the British Virgin Islands, Panama and the Dominican Republic, and to exports from Puerto Rico to which value has been added in those countries and territories. Tariff exemptions are granted to all products from that area, except those excluded by law (textiles, clothing, footwear, leather manufactures and some timepieces), and are accompanied by other advantages such as technical assistance, tax incentives for United States enterprises and programmes to promote trade and investment. In 1992, the products imported under the Act (excluding those that were also eligible for GSP treatment) amounted to US$ 645 million, and the Act accounted for 7% of all United States merchandise imports from the Caribbean Basin countries (ECLAC, 1992c).

The system of trade preferences for the Andean countries is intended to help Bolivia, Colombia, Ecuador and Peru in their efforts to combat the production of narcotic drugs, specifically through incentives for producing alternative crops that can be exported to the United States. To that end, tariff exemptions will be granted to a group of products for 10 years. It has been estimated that the programme will affect about US$ 300 million worth of imports, representing about 5% of total imports from those countries.

The European Community also grants preferences outside the GSP under regimes that primarily favour African, Caribbean and Pacific (ACP) countries that were once colonies of the nations that make up the Community. A second level of preferences benefits Mediterranean countries, and some preferences are also granted to Latin American countries.

The African, Caribbean and Pacific countries have signed the Lomé Conventions with the European Community. The latest of these agreements, Lomé IV, includes 69 developing countries, which receive institutional, trade and development cooperation benefits. The trade benefits favour two types of products: industrial (which enjoy complete freedom from customs duties) and raw materials. The latter are subject to two specific systems: the

9 These benefits will be phased out as a result of Mexico's Free Trade Agreement with the United States and Canada.

Stabilization System for Export Earnings (STABEX) for tropical products, and the special financing facility for ACP and OCT mining products (SYSMIN). When any of these countries experiences a decline in its export earnings, the Community makes transfer payments to offset the deterioration in that country's trade balance.

As regards the countries bordering the Mediterranean, all of them, with the exception of Libya and Albania, have concluded bilateral agreements with the Community that provide, *inter alia*, for the elimination of tariffs on industrial products, though with some restrictive exceptions, as in the case of textiles. The Mediterranean countries, however, are excluded from the income stabilization mechanisms applied to the African, Caribbean and Pacific States. Agricultural imports from these countries are also subject to quotas that limit the partial reduction of tariffs.

In 1990 the Community adopted a series of exceptional temporary trade measures in response to the special programme of cooperation proposed by the Colombian Government in the context of the international anti-drug effort. A special trade regime was set up for Bolivia, Colombia, Ecuador and Peru to exempt a special list of agricultural products from quotas and tariffs for a period of four years. In December 1991 these benefits were extended to agricultural products from the Central American Common Market and Panama to stimulate the process of democratization and economic reform.

3. Price fluctuations and futures markets

Clearly, a major problem for Latin American exporters is price instability, especially for commodity exports (see chapter I, table I.5). With the general trend towards less State involvement in the economy, market-based solutions, such as futures and options markets, have begun to replace non-market schemes, such as buffer stocks or cartels. Indeed, the last two decades have witnessed spectacular growth in conventional commodity futures and options markets and in a variety of related financial instruments. Markets have also become much more complex in this period, thus increasing the risks and difficulties for relatively inexperienced traders, such as those in Latin America and the Caribbean.

Not all products are suitable for futures markets. The commodities that lend themselves best to stock exchange operations are those that satisfy certain conditions in terms of a large volume of supply and demand, homogeneity and fungibility, and storability. Thus, trading in fuels is by far the largest area, followed by aluminium, copper, gold and silver. The contract volume traded for agricultural commodities, particularly "soft" commodities such as coffee, cocoa, cotton and sugar, is much smaller and the number of contracts traded varies widely from year to year (UNCTAD, 1993a).

Participation by developing countries, directly or through intermediaries, is limited but increasing. Latin American exporters of soft commodities are among the major developing-country users, hedging about a quarter of the region's cocoa, coffee and sugar exports on the Coffee, Sugar and Cocoa Exchange in New York (López Huebe, 1990). Latin American exporters of cereals and soybeans also hedge on United States exchanges (Regúnaga, 1990). For metals, Latin American exporters are active users of the exchanges. The region's copper producers and processors of semi-finished copper products in Brazil, Chile, Mexico and Peru, have regularly used the London Metal Exchange and the New York Commodity Exchange (COMEX) (Bande and Mardones, 1990), though for a rather small share of their total exports. Mexican and Brazilian authorities have participated actively in oil futures and options.

The exchanges offer two main types of commodity risk management instruments. The first is a *futures contract*, which is an agreement to purchase or sell a commodity at a price determined in the pres-

ent, for delivery of the merchandise after a given period of time. The most frequently mentioned benefit to be derived from futures contracts is hedging. Hedging allows producers, traders and processors to transfer at least a part of the risk associated with price fluctuations to a speculator, who hopes to realize a profit as a result of price variation.

The other main instrument is an *option*, which gives the purchaser the right, but not the obligation, to buy (call) or sell (put) a commodity at a pre-determined price after a given period of time. While a futures contract is binding on both parties, the purchaser of an option can walk away from the contract if he deems this convenient. Like futures, options can be used by producers to shift the risk of price changes.

Despite the benefits that are often attributed to the futures and options markets, there are also significant problems. One relates to liquidity: the volume of trade in practically all commodity futures and options, especially for more distant months, is not very high. In general, the commodity exchange options traded have short maturities, with few transactions extending beyond one year. Over-the-counter trade, an active trade in options of up to three years, is developing, but commodity risk management instruments offered by the exchanges with maturities greater than one year are generally difficult to acquire.

Another problem is the high cost of using commodity futures and options exchanges, either directly or through intermediaries. To participate directly, it is necessary to purchase a seat or membership on an exchange. Also, a participant usually needs an office in the city in which the exchange is located, and must meet capital adequacy standards and acquire accounting services to comply with audit and reporting requirements. These costs tend to work to the detriment of smaller firms. Indirect use through intermediaries also involves costs, such as margin deposits and margin calls, commission fees and organizational costs (e.g., staff training and access to daily information). Whether or not commodity buyers and sellers will consider it worthwhile to incur these costs largely depends on their location, the size of their trade deals and the frequency with which they need to resort to these markets.

In addition to these explicit costs, there are other implicit features that might deter potential traders from using the exchanges. One is the low reliability of futures market prices as predictors of future spot prices. In fact, a growing number of empirical studies tend to reject futures prices as predictors of future spot rates. (For a more extensive discussion, see Choe, 1990.)[10] Typically, commodity futures prices forecast the subsequent spot prices poorly, owing to either market inefficiency or irrational expectations, or the existence of premiums charged to risk-averse investors (Thompson, 1983; Choe, 1990). It is also clear, however, that they can provide short-run stability, at a cost, to risk-averse producers. In this sense, futures and options are a "good thing".

The exchanges are also said to be partially responsible for the increase in commodity price volatility (Thompson, 1983). Excessive short-term volatility in futures markets may cause the relationship between physical and futures market prices to change frequently, exposing hedgers to excessive risks and higher transaction costs. Many speculators operate on the basis of a technical analysis that is founded on assumptions about the behaviour of market agents and prices. Basing themselves on information about prices, trad-

10 The most commonly used technique for testing for bias in futures prices is to regress changes in spot prices on the futures discount. Choe's analysis, based solely on commodities, clearly rejects the hypothesis that futures markets are good predictors of future spot prices, coinciding with the results of other studies of foreign exchange futures markets. In his test of eight commodities of great interest to Latin America and the Caribbean, for the period 1980-1988, he finds evidence against the rationality of futures prices.

ing volumes, open-interest positions and other indicators, these speculators take various positions in the market. When a large number of them take the same position, their activity tends to bear out their short-run forecasts. They are said to prompt price movements that run counter to trends in fundamental economic variables, thereby distorting the market's long-term signals to industry. This distortional effect has increased in recent years owing to the greater incidence of institutional speculators. These speculators take decisions by comparing the risks and returns offered by various instruments, and their reference is eminently short-term. The waves of commodity purchases or sales resulting from this type of reaction exaggerate price fluctuations unrelated to market fundamentals and thus increase volatility.

In addition to these overall constraints at the world level, there are elements that might particularly limit the usefulness of futures markets for developing-country commodity exporters. Two such elements are mentioned here.

i) Price trends on the exchanges of developed countries and in local markets of developing countries can vary substantially. In the case of grain, for example, a temporary imbalance between supply and demand in the major producing countries can lead to competition between local consumption and exports that will be reflected more markedly in f.o.b. prices than on the Chicago Board of Trade (CBOT). The cross-seasonality of the northern and southern hemispheres can cause unpredictable variations in premiums. Such differences are one of the main obstacles to greater participation by developing countries in futures and options markets.

ii) Lack of information about and experience with futures markets hinders the advantageous use of these markets. For example, the level of optimal hedging can be substantially less than expected output when price and production uncertainties are high. Participants may find that the quantity to be hedged is a decisive variable, instead of always assuming completely hedged positions. Experience is necessary to take such decisions. More generally, developing-country participants are likely to have less information on trends which would enable them to take profitable decisions —or avoid heavy losses.

In so far as futures markets can lower risk and price volatility, they have an important role to play for commodity producers. Their growing use by producers and exporters in developing countries indicates that these actors see benefits to be gained from participation in the markets. Clearly, however, futures markets have not completely solved the problem of risk (actually, they only help to partially reduce short-term risks), and in some instances they may even exacerbate it. Many more institutional measures must be taken to improve the operation of the markets, and economic agents in developing countries need to increase their knowledge of the markets' functioning in order to decide whether to participate.

4. Foreign capital and international trade

Over the last decade, an increasingly close link has developed between foreign capital and international trade. First, much more foreign direct investment (FDI) has gone into export sectors than in the earlier postwar period. Second, an increasing share of international trade is being carried out by transnational corporations, either as intra-firm trade or through retail chains or trading companies.

During the 1970s, FDI was marginalized by private bank loans. Investors would not have been enthusiastic in any case, of course, since economic nationalism peaked in the 1970s, when many foreign firms were nationalized. With the onset of the debt crisis and the cessation of private-bank lending, however, developing countries again became interested in attracting direct investment. They not only instituted macroeconomic reforms, but also changed their rules on FDI to create a

more hospitable atmosphere. For example, price and exchange controls were reduced, and profit remittance was made easier. Rules limiting the entry of transnational corporations (TNCs) into key industries were cut back, and foreign investment codes were made more liberal (United Nations, 1991 and 1992).

After a time, transnational corporations began to respond positively. Table II.2 shows the pattern of FDI flows between 1980 and 1992, illustrating the drop in FDI to developing countries during the second half of the 1980s and the recovery in the 1990s. The Latin American share was largely responsible for this stop-go pattern. Initially, FDI in the region picked up as a result of debt-equity swaps and privatizations. In the last two years, "normal" FDI flows have also risen significantly (see chapter IX).

An important characteristic of the new investment flows to developing countries is that they have gone primarily into export sectors, rather than production for the domestic market, as in earlier decades. In a few cases, this has meant investment in natural resources. Chile and Colombia are prime examples of countries where the bulk of recent FDI flows have gone into commodities (copper, forestry and fishing in Chile; oil and coal in Colombia). More often, FDI has gone into manufactures, as in East and South-East Asia. In addition, some Latin American countries —especially Mexico, but also Venezuela and Brazil— have been significant recipients of manufacturing investments. Services, in-

Table II.2
INFLOWS OF FOREIGN DIRECT INVESTMENT TO DEVELOPING REGIONS, BY REGION, 1981-1985, 1986-1990 AND 1991-1992
(Billions of dollars and percentages)

Recipient region/ economy	Annual average (billions of dollars)				Share of total inflows (percentage)				Annual growth rate (percentage)			
	1981-1985	1986-1990	1991	1992[a]	1981-1985	1986-1990	1991	1992	1981-1985	1986-1990	1991	1992
All countries	50	155	149	126	100	100	100	100	-1	22	-27	-15
Developing countries	14	26	39	40	26	17	26	32	-4	14	24	3
Africa	2	3	3	2	3	2	2	2	12	6	21	-33
East, South and South-East Asia	5	13	20	21	10	9	13	17	-3	21	8	5
Latin America and the Caribbean	6	9	15	16	12	6	10	13	-10	9	53	7
Oceania	0.1	0.2	0.1	0.5	0.3	0.1	0.1	0.4	-2	27	-57	400
West Asia	0.4	0.4	0.8	0.8	1	0.3	0.5	0.6	7	27	61	0
Least developed countries[a]	0.2	0.1	0.2	-	0.3	0.1	0.1	-	-0.4	1	12	-
Ten largest recipient countries	9[c]	17[d]	25[e]	26[e]	18[b]	11[c]	16[d]	21[e]	-9[b]	18[c]	44[d]	4

Source: UNCTAD, *World Investment Report, 1993. Transnational Corporations and Integrated International Production* (ST/CTC/156), New York, 1993. United Nations publication, Sales No. E.93.II.A.14.

[a] Estimated. [b] Malta and Yugoslavia. [c] Argentina, Brazil, China, Colombia, Egypt, Hong Kong, Malaysia, Mexico, Nigeria and Singapore. [d] Argentina, Brazil, China, Egypt, Hong Kong, Mexico, Nigeria, Singapore, Taiwan Province of China and Thailand. [e] Argentina, Brazil, China, Indonesia, Malaysia, Mexico, Republic of Korea, Taiwan Province of China, Thailand and Venezuela.

cluding airlines and telecommunications, have been the latest sector to attract large-scale FDI.

Table II.3 links FDI to manufactures exports, focusing on United States and Japanese subsidiaries in developing countries in 1982 and 1989. The absolute value of exports produced by the two countries' TNCs increased rapidly, and export propensity rose from 22% to 33% among United States firms and from 33% to 39% among Japanese firms. For developing countries as a whole, the foreign share of manufactures exports fell. In the case of United States subsidiaries, their declining share of developing country exports was entirely attributable to the Asian countries. In Latin America and Africa, their share of exports rose significantly.

In Latin America, data on the 1,000 largest national or foreign firms in the region show that in 1991, TNCs generated 22% of total exports and over 44% of manufactures exports of these firms (Calderón, 1993a). Particularly notable were chemicals, rubber products, electrical and non-electrical machinery and automobiles, industries where foreign firms accounted for over 75% of exports. Nevertheless, the Latin American domestic market continued to be the main attraction for the 1,000 largest firms, since they exported only 17% of their total output. This figure was heavily influenced by Brazil, however, where the export coefficient for TNCs (exports as a proportion of total sales) was only 11%, compared to Chile and Mexico, where it was 33% and 29%, respectively (Calderón, 1993a).

An important sub-category of TNC exports are those sold within the firms themselves, a practice known as intra-firm

Table II.3

DEVELOPING COUNTRIES: MANUFACTURES EXPORTS BY UNITED STATES AND JAPANESE MAJORITY-OWNED FOREIGN SUBSIDIARIES
1982 AND 1989

Country group	Total manufactures exports by developing countries (millions of dollars)	United States subsidiaries (percentage)		Japanese subsidiaries[a] (percentage)	
		Share	Export propensity[b]	Share	Export propensity[b]
All developing countries					
1982	166 581	6.7	22.0	4.8	32.8
1989	451 986	5.7	33.1	2.9	39.2
Africa					
1982	10 579	1.6[c]	-	0.2	8.2
1989	16 809	3.4	-	0.2	15.2
Asia and the Pacific					
1982	94 314	6.3[c]	60.3	6.3	33.6
1989	332 120	4.2	56.2	3.5	40.2
Latin America and the Caribbean					
1982	44 814	10.5	11.9	2.2	18.6
1989	71 315	14.3	21.4	1.1	23.9

Source: United Nations, *World Investment Report, 1992. Transnational Corporations as Engines of Growth* (ST/CTC/130), New York, United Nations Centre on Transnational Corporations, 1992. United Nations publication, Sales No. E.92.II.A.24.

[a] Figures cover April 1982-March 1983 and April 1988-March 1989, and represent only a sample of subsidiaries in developing countries. [b] Export propensity is defined as the proportion of export sales in total sales by subsidiaries.
[c] Some of the data are omitted by the source to avoid disclosure.

trade. The growing importance of intra-firm trade is a consequence of efforts to achieve international competitiveness (through economies of scale or the use of specific national advantages) and of the need to avoid tariff and especially non-tariff barriers.

A recent study shows that more than a third of United States foreign trade in 1989 took place within firms; no overall estimates are available for other countries (OECD, 1992). For Latin America, some data exist on intra-firm trade by United States corporations. In 1989, for example, 27% of Mexico's exports to the United States and 42% of imports from that country were intra-firm operations of United States companies (United Nations, 1992). For Brazil, it is estimated that 14% of manufactures exports to the United States in 1990 were United States intra-firm transactions (Baumann, 1993a). The motor vehicle and electronics sectors are especially important participants in this form of trade.

The increasing importance of intra-firm transactions may pose certain problems for developing countries. Such operations involve the replacement of market transactions by those internal to firms. Among other consequences, trade flows may become less sensitive to relative prices, undermining the effectiveness of exchange rate policy, for example. At the same time, customs and fiscal policy can be adversely affected, since firms' internal operations facilitate the use of transfer pricing and make it more difficult to levy taxes and adopt anti-dumping measures.[11]

Direct investment, however, is not the only way in which TNCs have increased exports from developing countries. Especially in East Asia, but also (though to a lesser extent) in Latin America, subcontracting has become increasingly important. Gereffi (1994) distinguishes among three levels of subcontracting. The lowest level is export processing zones (EPZs), which specialize in the assembly of simple manufactured goods, especially apparel and electronics. The second level is "component-supply subcontracting", which involves the manufacture and export of component parts for technologically advanced industries, with final assembly usually carried out in developed countries. Automobiles and computers are prime examples of industries using this form of subcontracting. Finally, there is "original equipment manufacturing" (OEM) or the production of finished consumer goods by local firms. These goods are tailored to the specifications of large retail chains, which then market them abroad. Most of this kind of activity takes place in East Asia, where many backward linkages with the local economies have made it an important ladder to the highest level of exports: goods produced and marketed under the name of manufacturers themselves in newly industrializing economies (NIEs). (On subcontracting in the footwear industry in Brazil, see box II.2.)

The East Asian NIEs have managed to confront the effects of high wages and import quotas, which could drive them out of subcontracting, by setting up "triangle manufacturing". In this process, retail chains place orders with NIE manufacturers, who then subcontract to factories in low-wage countries, such as China or Vietnam. The triangle is completed when the goods are shipped back to the industrialized country under the quota of the latter countries. These triangle networks are being extended to Latin America and the Caribbean and to Africa, as well as to the rest of Asia.

Trading companies are yet another means by which foreign capital has promoted developing-country exports. They are mainly an Asian phenomenon, but their impact has spread to other developing regions, including Latin America. The most important trading companies are Japan's giant *sogo shosha*, which have offices in virtually every country in the world and provide marketing, financial

11 Some recent evidence, while not denying that transfer pricing has occurred, plays down its importance as a reason for intra-firm trade (Blomstrom, 1990).

Box II.2

SUBCONTRACTING IN BRAZILIAN FOOTWEAR EXPORTS

Brazil has become an important exporter of leather footwear, as can be seen in the following table:

Year	Thousands of pairs exported	Thousands of US$
1964	133	172
1970	3,776	8,273
1980	49,030	386,872
1989	169,979	1,238,280

There were several factors that led to Brazil's success, when other potential exporters (such as Argentina) failed. First, Brazil has a comparative advantage in footwear because of its leather and cheap labour, although Argentina and Uruguay also have a comparative advantage in leather. Second, Brazilian government policies encouraged exports. These policies included subsidies, an efficient exchange rate policy, credits and marketing assistance. These export policies alone, however, were not sufficient to enable the firms to make major headway into the United States market. Third, and arguably most important, United States importers decided to make Brazil a major source of cheap footwear. Through their agents, they provided the necessary know-how, access to the United States market and protection against attempts by United States producers to limit the entry of Brazilian footwear to that country.

United States agents are involved in every aspect of the production process in Brazilian footwear firms. They carry out fashion research and make prototypes of particular styles, which are then turned into samples that are sold to wholesalers and retailers in the United States. After these firms place orders, the export agents negotiate with the factories that will produce the shoes. They also ensure that the specified leather is purchased by the shoe factory. They supervise production to make sure that deliveries will be on time and, finally, they ship the shoes.

At the global level, agents and especially importing firms have managed to prevent protectionist measures from being imposed against Brazilian footwear. This contrasts with the success of United States steel manufacturers in obtaining sanctions against Brazilian producers, which in the case of steel are State firms and local private capitalists. There is no doubt that United States steel firms are more politically powerful than their counterparts in the footwear industry, but having allies in the importing market who have a major stake in their exports is also important for Brazilian footwear manufacturers.

While Brazilian producers dislike the power of the export agents, most feel they do not have the capacity to market on their own. This is especially true since most footwear firms are small (the average number of employees is under 50). Also, fashions change frequently, demanding constant knowledge of the market. It is also expensive to set up offices in the United States and hire and train staff. The commissions charged by agents are generally low, around 3%, but the highest profits are usually made by global production-marketing chains. As a result, Latin American producers should try to find marketing channels, whether national or international, instead of waiting for their products to be bought.

Source: Jeffrey Cason, "Development Strategy in Brazil: The Political Economy of Industrial Export Promotion, 1964-1990", Ph.D. dissertation, University of Wisconsin-Madison, 1993.

and information services to other firms. Initially, they helped Japan's own large manufacturing firms to move abroad, but when the latter outgrew their need for such assistance, the *sogo shosha* turned to smaller Japanese companies and firms from developing countries (Kojima and Ozawa, 1984).

The Japanese trading companies have been especially active in Asia. Their share in the Asian and Pacific countries' total trade was estimated at 17% at the beginning of the 1980s (Kuwayama, 1992). In the late 1980s, the largest *sogo shosha* managed an average of US$ 2-3 billion per year of Latin America's exports and imports,

meaning that the trading companies handled over half of the region's US$ 18 billion trade with Japan. In addition, during the 1980s these firms began to promote Latin American exports to third countries, including the United States. It is estimated that they were responsible for roughly 10% of Latin America's total trade of US$ 200 billion in 1989 (Stallings, 1991).

In some cases, the *sogo shosha* simply act as intermediaries, assuming responsibility for shipping and financing goods produced by independent firms. In others, they take a small equity share in a firm in order to secure a source of supply or gain more influence over the quality of the products. A third function has been to discover investment opportunities and bring in other Japanese companies, which provide most of the capital. In the last few years, some of these investments have been joint ventures with United States firms (e.g., for the production of liquid natural gas in Venezuela and copper in Chile). Working through the trading companies has been the most feasible way for developing countries to gain access to the Japanese market.

5. International trade and the environment

Environmental issues are rapidly becoming a major factor in international trade. Often, from the developing countries' point of view, environmental concerns have been regarded as just one more type of protectionism on the part of the industrial nations. However, the issue goes deeper than such an instrumental approach would imply. The environment is becoming an aspect of international competitiveness, which can confer advantages as well as impose costs.

Environmental requirements are becoming increasingly stringent in the 1990s, meaning that economic agents are having to change their strategies and decision-making practices. In the developed countries, clear indications of the direction this process is taking include the lower proportion of raw materials used and waste generated in the manufacture of the final product, the adoption of strict environmental regulations and increasing consumer concern for the environment. These facts are leading to the redesign of industrial processes, marketing channels and systems for the final disposal of products.

In view of the critical volumes of waste and residues and the growing shortage of dumps and deposit sites, the disposal of a product at the end of its useful life is becoming increasingly costly, and recycling, re-using and minimizing waste therefore appears to be an economically viable option for producers. Consumers, for their part, are beginning to regard environmental quality as a distinctive, desirable product feature. One indication of this trend is that a recent survey in France found that consumers are willing to pay more if they are certain that the processes used in manufacturing the goods they buy are less polluting (France, Ministère de l'environnement, 1993).

Another sign of this trend, which goes beyond the problem of pollution and extends to the conservation of renewable natural resources, is provided by a number of market studies done in Europe on wood products. These studies show that a large and growing proportion of consumers would be willing to pay more for wood products from sustainable forestry sources (*Décision environnement*, 1992; World Resources Institute, 1993).

The foregoing trend is in keeping with a process of product differentiation representing a concern for both quality and control. This concern is illustrated by the combative attitude of the consumer in the most highly developed countries, by the action of "green groups" and neighbourhood organizations, and by increased awareness on the part of traditional political parties. In addition, industry itself has exerted pressure on Governments to prevent "unfair competition" from products originating in economies that do not have environmental protection policies. As a result of all these pressures, Governments are beginning to impose limitations on the

free movement of goods harmful to the environment.

Indeed, various quality control systems for production and products have been in the pipeline for some time. Two dynamic features of these systems stand out. First, as they are incorporated into the market, they are being standardized and are gradually changing from voluntary to formal and, in some cases, compulsory systems. Second, quality control systems are tending to focus less on product quality than on quality of management, since the former depends on the latter. Standards applying to a product's environmental impact during all phases of its life-cycle, from the production of its natural inputs to the final destination of the waste it generates once it has been consumed or its useful life has ended, are now being formulated.

The fluidity and stability of world trade depend on the existence of a series of rules that have been duly harmonized on the basis of mutually agreed criteria and incorporated into international agreements. One instrument which is gaining in importance is the "environmental quality seal": it represents a new set of standards that are playing a growing role as external determinants of trade and that should be taken into account in any export strategy (see box II.3, on environmental labelling in Europe).

An outstanding example of the use of environmental quality seals is the effort being made by the newly formed Forest Stewardship Council, whose purpose is to oversee the world-wide certification of wood from the best-managed forests. One indicator of the possible consequences of this certification is the change that has occurred in the United States market: increasingly aware of the importance of protecting native forests, it has begun to reject furniture manufactured in Malaysia, Thailand and Indonesia with native wood from virtually non-renewable forests. This new attitude has also had a positive impact on Chilean exports of products made with Monterey pine (from plantations), the demand for which has increased significantly in the United States market. In the case of wood, the "green seal" might even become a factor in the competitive advantage of this product, and wood that does not bear this seal might be excluded from a growing proportion of global markets. It is fairly likely that other goods produced from marine and other renewable natural resources will receive similar treatment, by either Governments or consumers.

In the developed countries, pressures towards better environmental management have produced an internalization of the relevant costs. At the institutional level, these have resulted in the adoption by the OECD countries in 1985 of the "polluter pays principle". The formulation of this principle is intended to quantify environmental impact and classify the generating sources on the basis of this impact, which until now has been dispersed, diffuse and uncontrolled economically. In contrast, in the developing countries, including those of Latin America, these costs are generally not included in the price of their main exportable commodity, raw materials (Biggs, 1992). This asymmetry tends to accentuate the deterioration of the terms of trade for such commodities.

One of the causes of this asymmetry is the greater institutional weakness of the developing countries, the fragility of their legal and regulatory framework and their limited capacity to monitor and control environmental damage. Perhaps a more basic cause is that these countries are less interested in internalizing the environmental costs in their main exports for fear of losing competitiveness in global markets.[12]

The logic of world trade, therefore, is operating in such a way that, through the structure of international prices, all countries (all consumers) are bearing the mon-

12 Strictly speaking, this is a spurious component of competitiveness, since the absence of environmental standards leads them to underestimate or even disregard a real production cost or a negative externality.

Box II.3

ENVIRONMENTAL LABELLING IN EUROPE

At the end of 1992, the environment ministers of the European Community agreed to establish a system under which a uniform environmental seal would be used throughout Europe.

Each member State would have an organization responsible for awarding the seal on the basis of a series of principles to be defined by a committee composed of representatives of Community governments, industries, consumers, non-governmental environmental organizations and trade unions.

Currently being discussed is the establishment of these seals for a series of products based on their environmental friendliness, in terms of water and energy consumption and the recyclability of some of their components. These products are washing machines and dishwashers, light bulbs, hair sprays, paper for general use and toilet paper. The objective would be to label products with a detailed description of their features so that the consumer can choose freely what products he or she will buy on the basis of information on their environmental impact.

This initiative is not immune to criticism. However, most of the arguments seek to correct and perfect the instrument, *inter alia*, by establishing better criteria in relation to product life-cycle and recyclability, suggesting certain assessment procedures and making a sort of life-cycle inventory in the European market. It appears that no one is questioning the need to inform consumers about these aspects of the "environmental quality" of the products they are being offered.

Source: James Salzman, *Environmental Labelling in OECD Countries*, Paris, Organisation for Economic Cooperation and Development (OECD), 1991.

etary costs of controlling environmental degradation in the industrialized countries internalized in the price of their products for domestic consumption and for export and at the same time financing these countries' efforts to find new ways of adopting clean technologies, minimizing waste and saving energy and raw materials. On the other hand, environmentally related losses in the developing countries are being sustained by these countries alone. Since these costs are not transferred to the price of the product, these products are in fact being subsidized for consumers throughout the world, and this hidden environmental subsidy is inhibiting or delaying the development and implementation of clean technologies and other environmentally friendly practices.

To obviate this situation, the countries of the southern hemisphere must find a way of including in the prices of their products the costs of environmental protection, i.e., the outlays involved in the installation of decontaminating equipment and adoption of clean technologies, and the economic costs of the sustainable use of natural resources, especially non-renewable ones. The best solution would seem to be to resort to international negotiation, in which producers of natural resources in both developed and developing countries would be included. This would be a way of mitigating the fear of acting individually and possibly risking the loss of markets.

If multilateral action is not feasible, the countries of the region could in any case begin a process of identifying certain clean products for which they can charge a premium. Agricultural products are especially promising in this sense, since consumers in developed countries are apparently willing to pay more for healthful foods. Moreover, as indicated above, it would be important to initiate a process in the region aimed at improving the countries' institutional capacity to monitor and control environmental damage and ensure compliance with international agreements.

Obviously, in the near future, these changes will become key components of international competitiveness, and the countries that are first to incorporate them will have an opportunity to acquire competitive advantages. The nations of Latin America and the Caribbean, and of the southern hemisphere in general, have already fallen behind and should not wait any longer to move ahead in this field. Besides, trade liberalization and export promotion may aggravate the damage to ecosystems that is already being caused by the production system. In considering issues related to changing production patterns and adjusting them to the requirements of a more open, transnational system, special attention should be given to this aspect of sustainability.

Chapter III

EXPORT PERFORMANCE IN LATIN AMERICA AND THE CARIBBEAN

1. The new look outward

At the beginning of the 1980s the countries of the region adopted adjustment policies in order to cope with the external constraint (ECLAC, 1984a and 1986). Gradually, however, they moved towards a global change in their economic policy which, *inter alia*, included drastic trade reforms. After transitional measures that entailed a high social cost, most of the countries succeeded in boosting their export coefficients and in considerably improving the management of their economic policy. These efforts resulted in lower inflation, better fiscal performance and, since the beginning of the 1990s, a certain recovery of growth and, to a lesser extent, of savings and investment rates.

The higher real foreign exchange rate brought about by the external debt crisis and the domestic recession triggered by the adjustment policies of the early 1980s, followed by trade reforms, encouraged a significant change in the structure of production. Some enterprises were restructured, some disappeared, and new activities began.

This gradual transformation of the production structure is reflected in the higher ratio of exports to GDP and in the diversification of exports, in increased competitiveness from a growing number of firms and in a notable improvement of entrepreneurial capacity to explore external markets and gain access to them.

This restructuring, characterized inter alia by an increase in the relative presence of exportable items in total production, has shown signs of a growing flexibility in adapting to the changes in relative prices and to world market trends. The advances achieved in economic stability have favoured a greater flow of foreign direct investment and, in general, better access to external financing and the repatriation of capital, in certain economies. As a result, savings and investment recovered, but still insufficiently. Finally, and no less importantly, the countries resumed their patterns of regional cooperation and integration, moving towards a position of greater openness. They were thus able to sign a number of trade agreements designed to establish free trade zones or to use intraregional trade as an instrument to improve their economies' linkages with the global economy.

The economic results achieved in the early 1990s show that there was a certain recovery of growth, to a large extent associated with the new balance-of-payments position. Of special note in this case is the net transfer of resources to the region from abroad, representing about 2% of regional GDP, which is helping to finance the regional current account deficit (3.4% of GDP in 1993); this has been a growing trend since 1990, in line with a similar trend in the merchandise trade balance (see table III.1).

Table III.1
LATIN AMERICA AND THE CARIBBEAN: CURRENT ACCOUNT AND TRADE BALANCES
(Percentages of GDP)

	1985	1986	1987	1988	1989	1990	1991	1992	1993
Current account	-0.5	-2.5	-1.4	-1.3	-0.7	-0.6	-1.8	-3.1	-3.4
Trade balance (goods)	5.7	2.6	2.9	3.0	3.9	2.5	0.8	-0.8	-1.2

Source: ECLAC, in 1980 dollars, on the basis of official data.

a) Exports and growth in the long term

In general, the ratio between the expansion of exports and overall economic growth has been low in the countries of the region during the 1970s and 1980s. The link between the two variables, already in many cases weak in the first of these decades, became even more tenuous during the crisis of the 1980s, when, on the one hand, the recession affected the level of domestic activity and, on the other, the need for external adjustment encouraged export growth. With a few exceptions, the liberalization processes which have reduced the anti-export bias of economic policy are still recent. Also recent are the stabilization processes characterized by the adoption of export incentives, coupled with lower inflation rates and better fiscal discipline. On the other hand, the comparatively high real exchange rates with which these processes began have tended, in many cases, to become eroded as a result of the new abundance of external financing.

Thus, between 1970 and 1992, the volume of exports of goods from the region grew at an annual average rate of 4.0%. If Venezuela is excluded in order to isolate part of the effect of fuels on export prices and volumes, the expansion rate was 6.6% a year (see table III.2).

There are at least two important points to note in table III.2. First, in 14 of the 18 countries listed, the export effort (as reflected in the long-term growth rate of export volume) was higher than the variation, during the same period, in the purchasing power of exports.

The reasons for this differential are obviously associated with the type of trade specialization of the countries of the region and with its impact on the evolution of the relative prices of the export basket. The second point is that, for 10 of these countries (and for the whole of the region), the growth rate of merchandise exports was higher than that of GDP in those 20 years. Here again, however, considerable differences between subperiods exist.

Between 1980 and 1992, the region as a whole increased exports of goods and services at an annual average rate of 5%. The countries with the strongest export drive were Paraguay, Costa Rica, Chile, Mexico, Ecuador, Brazil and Colombia. Their volume of exports grew faster than the regional average. In the first half of the decade, Argentina, Brazil, Ecuador and Mexico were in the lead, but from 1985 onward the export drive spread to more countries. Besides in Ecuador and Mexico, the volume of exports of goods and services expanded at higher rates than those for the region as a whole in Bolivia, Chile, Colombia, Costa Rica, Dominican Republic, Panama, Paraguay and Venezuela (see table III.3).

The period 1980-1985 was one of recession or slow growth in the whole region because of the adjustments made in domestic demand in order to cope with the debt crisis or to bring about stabilization. The export boom, in those cases where it occurred, could do little, on its own, to counter the effects of these adjustments on the level of activity.

Table III.2
LATIN AMERICA: RATE OF GROWTH OF EXPORTS AND OF GROSS DOMESTIC PRODUCT, 1971-1992
(Annual rates obtained by regression, in percentages)

	Gross domestic product	Exports of goods	
		Volume	Purchasing power
Argentina	1.0	4.6	1.7
Bolivia	1.2	-2.4	0.6
Brazil	4.2	7.4	4.7
Colombia	4.2	5.1	5.0
Costa Rica	3.3	4.1	3.0
Chile	2.9	7.4	4.5
Ecuador	4.5	6.7	5.3
El Salvador	0.7	-1.0	-4.3
Guatemala	2.7	1.7	0.4
Haiti	1.7	3.4	2.3
Honduras	3.8	2.2	1.1
Mexico	3.9	11.4	10.5
Nicaragua	-1.2	-4.3	-5.4
Paraguay	5.6	9.2	8.1
Peru	1.3	0.6	0.0
Dominican Republic	3.8	0.1	-2.1
Uruguay	1.5	5.0	2.0
Venezuela	1.0	-2.2	1.6
Latin America (excluding Panama)	3.1	4.0	4.1
Latin America (excluding Panama and Venezuela)	3.3	6.6	4.6

Source: ECLAC, on the basis of official data.

During the period 1985-1992, there was a gradual and shaky recovery of growth. This was reflected in the fact that the annual average rate of growth of GDP climbed back to 2.3% a year, after being barely 0.5% between 1980 and 1985. The fastest growing countries in the most recent period (Colombia, Chile, Costa Rica, Venezuela, Uruguay and Paraguay) form part —with the sole exception of Uruguay— of the eight cases with the strongest export drive (see table III.3).

b) The recent export drive

In the 1980s, the countries of the region drastically modified their development strategy. In line with the world trends towards economic globalization, they steered their course back towards exports. This change of direction is reflected in the variations in their export coefficients. The most marked increases (above 50% of the coefficient) in the export drive between 1980 and 1992 —although on the basis of

Table III.3

LATIN AMERICA (19 COUNTRIES): GROWTH OF OUTPUT AND OF EXPORTS

(1980 dollars; average rates of annual variation)

(Exports of goods and services)

	1980-1985		1985-1992		1980-1992	
	GDP	Exports	GDP	Exports	GDP	Exports
Argentina	-2.0	8.2	2.6	2.4	0.6	4.8
Bolivia	-1.8	-6.4	2.5	5.6	0.7	0.4
Brazil	1.1	9.8	1.4	3.6	1.2	6.1
Colombia	2.5	-1.3	4.2	11.3	3.5	5.9
Costa Rica	0.1	4.3	4.4	10.5	2.6	7.9
Chile	-0.2	4.0	6.6	10.2	3.7	7.6
Ecuador	2.0	6.6	2.3	6.5	2.2	6.5
El Salvador	-2.0	-5.8	2.3	1.9	0.5	-1.4
Guatemala	-1.1	-4.0	3.2	3.0	1.3	0.0
Haiti	-1.0	2.1	-1.1	-12.9	-1.0	-6.9
Honduras	1.3	0.4	3.2	1.6	2.4	1.1
Mexico	1.9	10.3	1.9	5.0	1.9	7.2
Nicaragua	0.6	-5.4	-2.5	-4.9	-1.2	-5.1
Panama	2.6	0.8	1.3	5.2	1.9	3.3
Paraguay	2.3	4.7	3.3	13.2	2.9	9.5
Peru	-0.2	0.5	-1.6	-5.2	-1.0	-2.8
Dominican Republic	1.7	-1.0	2.4	6.1	2.1	3.1
Uruguay	-3.2	2.9	4.0	4.1	0.9	3.6
Venezuela	-2.0	-3.9	4.4	6.1	1.7	1.8
Total	**0.5**	**5.1**	**2.3**	**4.9**	**1.5**	**5.0**

Source: ECLAC, on the basis of official data.

different degrees of opening— have been those achieved by Argentina, Brazil, Chile, Costa Rica, Ecuador, Mexico, Paraguay and Uruguay (see figure III.1). Chile and Uruguay had already advanced in this direction in the previous decade.[13] The region as a whole raised its export coefficient from 14% in 1980 to 21% in 1990 and to 23% of GDP in 1993. Although this figure continues to be low at the international level, compared to the average for developing countries,[14] it represents a rapid increment in a brief period of time. It covers eight countries whose exports now account for 30% or more of GDP.

The reorientation of Latin America towards exports has not been sufficient, however, to turn back the region's declining relative share of world trade (see table I.4).

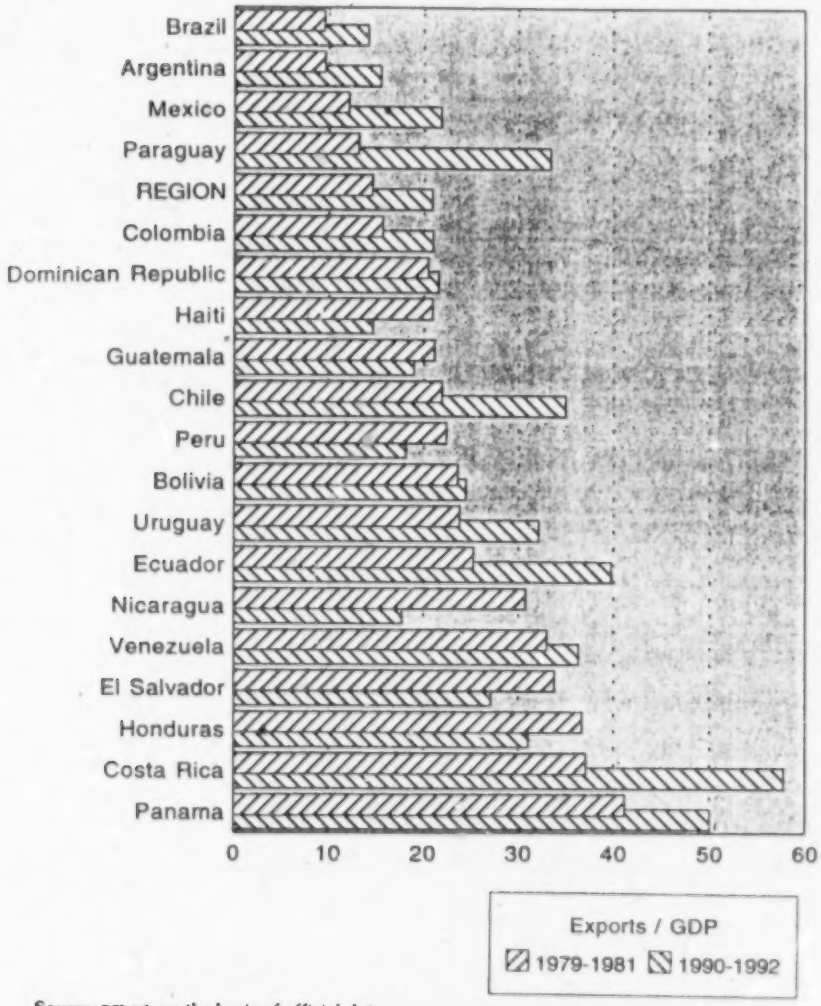
2. Export drive and terms of trade

The considerable export effort made by the region during the 1980s and the beginning

13 Generally speaking, there is an inverse relationship between the economic size of a country and its degree of export opening. This was particularly clear in the 1970s, when Argentina, Brazil and Mexico had the lowest export coefficients. In recent years, this relationship is less direct because the export strategy option seeks to boost the export coefficient as an economic policy aim, regardless of economic size. For example, Chile and Mexico now have higher export coefficients than a number of smaller economies.

14 The region's 21% export coefficient in 1990 is similar to the average export coefficient of OECD. It is slightly higher than the average of the low-income developing countries and is lower than the average of the developing economies with medium and high income (World Bank, 1991a).

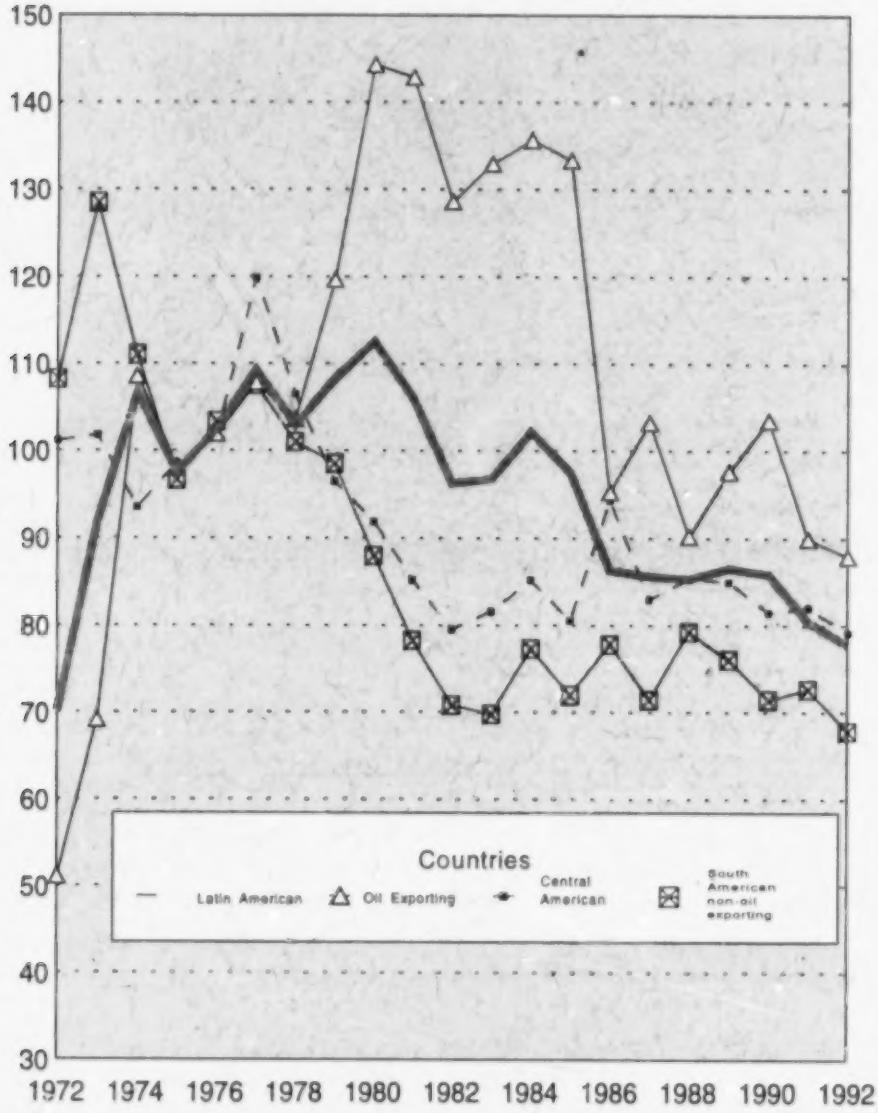
Figure III.1
LATIN AMERICA AND THE CARIBBEAN: RATIO BETWEEN EXPORTS OF GOODS AND SERVICES AND GDP (%)[a]



Source: ECLAC, on the basis of official data.
[a] The countries are listed in accordance with the coefficient for the period 1979-1981

of the 1990s was significantly undermined —in terms of purchasing power of exports— by the downward trend in the unit value of exports, the main factor in the deterioration of the terms of trade during the period (see figure III.2). Thus, in 1980-1992, while the region increased the volume of its exports by 87% (5.3% a year), their value increased only 43% (3% a year), as a result of a cumulative fall in prices of 23%. This situation is largely due to the countries' still marked dependence on primary commodities with a low degree of processing, whose prices tend to decrease and, around this decrease, fluctuate more sharply.

Figure III.2
LATIN AMERICA: TERMS OF TRADE (GOODS)
Index (1975-1976=100)



Source: ECLAC, on the basis of official data.

This trend in Latin America export prices and in its terms of trade in the 1980s must be viewed against the erratic behaviour of the prices of oil, other primary commodities and manufactures on world markets. In the 1970s, after the initial impact of higher oil prices on world inflation, the terms of trade of most Latin American countries kept fluctuating around a stationary trend until the end of the decade, and the purchasing power of exports generally increased at the same speed as the volumes exported.

From 1980 onwards, these trends were shattered. There was a second boom in oil prices. Then they fell to real levels lower than those of the first. Primary commodity prices tended to decline, in nominal terms, while the prices of manufactures imported by the region climbed back up, although at lower rates. The combination of both these trends triggered a sharp drop in the terms of trade of the non-oil-exporting countries in the early years of the decade. Between 1986 and 1990 some prices of Latin American commodities recovered,[15] a trend which slowed the decline but could not reverse it.

Later, in the early 1990s, most of the prices of the primary commodities exported by Latin America —including oil— decreased again, in some cases sharply. As a result, the terms of trade of nearly all the countries of the region fell too, as compared with 1990 levels (see figure III.2). The decline in the last three years (-18%) compounds the drop accumulated between 1980 and 1990 (-22%).

Since the mid-1970s, the decline in the terms of trade has had a greater impact on the non-oil-exporting South American countries than on those of Central America and the Caribbean, especially the oil-exporting countries. The latter, however, encountered a sharper fall in the 1980s because of the high prices of hydrocarbons at the beginning of that decade (see figure III.2).

3. Trends in sectoral exports

During the 1970s, the value of the manufactures exported by the region, with few exceptions, increased at a considerably faster rate than the value of total exports. A similar trend, although not so strong in most cases, occurred with semi-manufactures.[16] During the 1980-1987 period of stagnation or slow expansion in the value of exports caused by the price decline, few countries (Brazil, Colombia, Paraguay, Uruguay, Venezuela and, especially, Mexico) were able to maintain a significant drive in the exports of manufactures; most of them sustained the value of their exports on the basis of the growth of primary commodities.

Between 1987 and 1992, there was a general improvement in the export capacity of the region's economies. Except in El Salvador and Nicaragua, held back by domestic conflict, the remaining countries appreciably increased the value of their exports. In most cases, manufactures led the way, followed by semi-manufactures. Only in Argentina did the export drive come from primary commodities, although semi-manufactures and manufactures also grew at more than 10% a year. In Chile, the expansion of primary commodities was second to that of manufactures and above that of semi-manufactures (including copper). In Costa Rica, Guatemala, Paraguay, Peru and Uruguay, on the other hand, the most dynamic exports were those of semi-manufactures (see table III.4).

To sum up, the greater dynamism of manufactures exports has become a me-

15 Especially prices of certain minerals (copper, iron, lead, zinc) and some agricultural raw materials (leathers, wood, tobacco).

16 However, in this period, as a result of expanding oil exports, Mexico disproportionately increased its primary exports, and Chile boosted the value of its primary exports almost as much as the value of its manufactures, while the advance of its semi-manufactures, in which copper predominated, slowed down.

Table III.4

LATIN AMERICA: MERCHANDISE EXPORT TRENDS BY TYPE OF PRODUCT

		Annual growth rates in current dollars (%)			Elasticity with regard to the total		
		1970-1980	1980-1987	1987-1992	1970-1980	1980-1987	1987-1992
Argentina	Primary products	13.7	-8.3	16.1	0.84	(2.52)	1.15
	Semi-manufactures	18.4	0.2	14.1	1.13	-0.06	1.01
	Manufactured goods	21.6	0.7	10.9	1.33	-0.21	0.78
	Total	16.3	-3.3	14.0			
Bolivia	Primary products	19.1	-4.9	0.0	1.17	(0.6)	0.00
	Semi-manufactures	13.7	-16.1	15.3	0.84	(1.96)	2.55
	Manufactures goods	5.5	-11.9	54.9	0.34	(1.45)	9.15
	Total	16.3	-8.2	6.0			
Brazil	Primary products	12.8	0.4	1.9	0.58	0.10	0.29
	Semi-manufactures	28.8	1.6	5.3	1.30	0.41	0.82
	Manufactured goods	36.0	8.1	9.4	1.62	2.08	1.45
	Total	22.2	3.9	6.5			
Colombia	Primary products	16.2	2.9	3.8	0.88	0.83	0.58
	Semi-manufactures	23.0	5.6	3.7	1.25	1.60	0.56
	Manufactured goods	29.5	3.7	18.0	1.60	1.06	2.73
	Total	18.4	3.5	6.6			
Costa Rica[a]	Primary products	13.5	3.8	5.6	0.87	1.81	0.57
	Semi-manufactures	17.2	-5.4	19.8	1.11	-2.57	2.02
	Manufactured goods	21.3	-0.3	8.6	1.37	-0.14	0.88
	Total	15.5	2.1	9.8			
Chile	Primary products	19.3	6.9	16.0	1.38	5.31	1.09
	Semi-manufactures	12.5	-1.3	12.8	0.89	-1.00	0.87
	Manufactured goods	24.7	-0.7	26.2	1.76	-0.54	1.78
	Total	14.0	1.3	14.7			
Ecuador	Primary products	26.8	-1.8	10.5	0.91	(0.62)	1.33
	Semi-manufactures	44.2	-6.7	-11.2	1.51	(2.31)	-1.42
	Manufactured goods	33.4	-7.2	22.2	1.14	(2.48)	2.81
	Total	29.3	-2.9	7.9			
El Salvador[a]	Primary products	10.5	1.1	-20.8	0.86	-0.48	1.70
	Semi-manufactures	15.3	-4.9	-1.0	1.25	(2.13)	(0.08)
	Manufactured goods	14.3	-8.9	2.2	1.17	(3.87)	-0.18
	Total	12.2	-2.3	-12.2			
Guatemala	Primary products	17.7	-6.0	1.6	1.00	(0.90)	0.21
	Semi-manufactures	20.8	-9.3	20.4	1.18	(1.39)	2.68
	Manufactured goods	15.6	-6.7	12.0	0.88	(1.00)	1.58
	Total	17.7	-6.7	7.6			
Honduras	Primary products	17.4	0.3	-1.6	1.02	-0.33	2.29
	Semi-manufactures	12.9	-2.0	-9.2	0.76	(2.22)	(13.14)
	Manufactured goods	20.7	-16.4	29.3	1.22	(18.22)	-41.86
	Total	17.0	-0.9	-0.7			

Table III.4 (concluded)

		Annual growth rates in current dollars (%)			Elasticity with regard to the total		
		1970-1980	1980-1987	1987-1992	1970-1980	1980-1987	1987-1992
Mexico	Primary products	37.2	-2.4	-0.3	1.27	-0.59	-0.05
	Semi-manufactures	17.0	9.7	5.0	0.58	2.37	0.86
	Manufactured goods	16.3	25.0	13.2	0.55	6.10	2.28
	Total	29.4	4.1	5.8			
Nicaragua[b]	Primary products	10.5	1.1	-20.8	0.86	-0.48	1.70
	Semi-manufactures	15.3	-4.9	-1.0	1.25	(2.13)	(0.08)
	Manufactured goods	14.3	-8.9	2.2	1.17	(3.87)	-0.18
	Total	12.2	-2.3	-12.2			
Paraguay	Primary products	20.2	5.9	8.8	1.18	3.11	0.67
	Semi-manufactures	13.9	-9.0	23.5	0.81	-4.74	1.78
	Manufactured goods	15.2	7.4	22.2	0.89	3.89	1.68
	Total	17.1	1.9	13.2			
Peru[c]	Primary products	16.9	-8.6	5.9	1.36	(1.46)	0.41
	Semi-manufactures	6.6	-4.1	20.8	0.53	(0.69)	1.43
	Manufactured goods	46.8	-5.4	19.5	3.77	(0.92)	1.34
	Total	12.4	-5.9	14.5			
Uruguay	Primary products	11.4	-1.0	3.4	0.70	-0.53	0.56
	Semi-manufactures	18.2	3.2	10.3	1.11	1.68	1.69
	Manufactured goods	25.0	3.6	5.1	1.52	1.89	0.84
	Total	16.4	1.9	6.1			
Venezuela	Primary products	19.1	-10.4	4.6	0.97	(1.27)	0.79
	Semi-manufactures	21.0	-6.0	5.7	1.07	(0.73)	0.98
	Manufactured goods	25.0	14.2	17.4	1.27	-1.73	3.00
	Total	19.7	-8.2	5.8			
Items *pro memoria*:							
Unit value of exports of goods from Latin America and the Caribbean		17.6	-2.6	1.7			
Unit value of exports of manufactures from developed countries		11.1	2.2	4.0			

Source: ECLAC, on the basis of official data.

Note: 1. Exports have been classified in accordance with the criterion mentioned in ECLAC, "El comercio de manufacturas de América Latina: evolución y estructura, 1962-1989", Estudios e informes de la CEPAL, No. 88 (LC/G.1731-P), Santiago, Chile, November 1992, United Nations publication, Sales No. S.92.II.G.12, pp. 30-34.

2. The figures in brackets represent the quotient of negative rates.

[a] For 1970-1991. [b] For 1970-1991, the year 1988 being considered instead of 1987. [c] For 1970-1990.

dium-term feature of the exports of nearly all the countries of the region. This fact is in line with world-wide trends: in the last two decades, the volume of world trade in manufactures has increased twice as fast as the volume of primary commodities. In this period, world trade in manufactures grew at an average annual rate of 6.3% and Latin American exports of manufactures grew at a rate of 11%, although from initially low amounts and strongly influenced by the magnitude of Brazil's and Mexico's sales. The fact that, in the last two decades, for each percentage point of increase in world output, trade in manufactures went up 2%, while trade in primary

commodities rose only 0.6% (IDB, 1992), brings out how important it is to promote manufactures in designing strategies to maximize the contribution of exports to growth.

a) Agricultural exports

During the 1980s, the volume of agricultural exports increased at a rate of 2.3% a year; however, their value increased only at 1.4% a year as a result of the slight reduction in their unit value. Following sharp price declines at the beginning of the 1990s, the value of these exports in 1992 was barely similar to the average of 1979-1981.

This performance stands in contrast with the trend of earlier decades, especially the 1970s. At that time, the volume of exports grew faster than 4% a year, taking advantage of a price boom. As a result, the value of regional exports more than quadrupled during the decade. The slower growth of world food demand and the policies used to protect traditional crops in the developed countries brought about steep declines in their international prices, primarily in the 1980s. In this context, traditional crop exports from the region increased very slowly during that decade. This triggered substantial efforts to diversify agricultural exports and to penetrate new markets.

The agricultural export drive unleashed in the 1980s, in the face of a pronounced decline in the international prices of traditional products, is noteworthy because of the considerable expansion of non-traditional exports. A number of countries have succeeded in grasping new market opportunities for tropical and subtropical fruit and their derivatives and also for out-of-season horticultural produce. Growers have also developed new varieties that are easier to transport and store, taking advantage of new preservation technologies. With a few exceptions, it is the modern-sector producers who have adopted this dynamic approach to non-traditional exports and who have received most of the public support for their exports.

The favourable performance of non-traditional agricultural exports reflects the improvement in relative prices, resulting from depreciated exchange rates, tax deregulation and in some cases reduction, coupled with important advances in extractive and processing technologies, biogenetics and biomass handling techniques, which have extended the "frontier" of economically profitable agricultural resources (see chapter VI, section 3).

As a result, we may observe important changes in the composition of Latin American agricultural exports. The value of non-traditional exports (for example, fruits and vegetables —fresh,[17] frozen or processed— flowers, beverages and wine) tripled during the decade and their share in the agricultural exports of the Latin American Integration Association (LAIA) countries rose from 20% in 1983 to a third in 1990 (ECLAC, 1993a).

Some of the outstanding examples of non-traditional exports[18] closely linked to the agricultural resources of the region are crustaceans and molluscs —fresh, frozen, dried and salted— (Argentina and Pana-

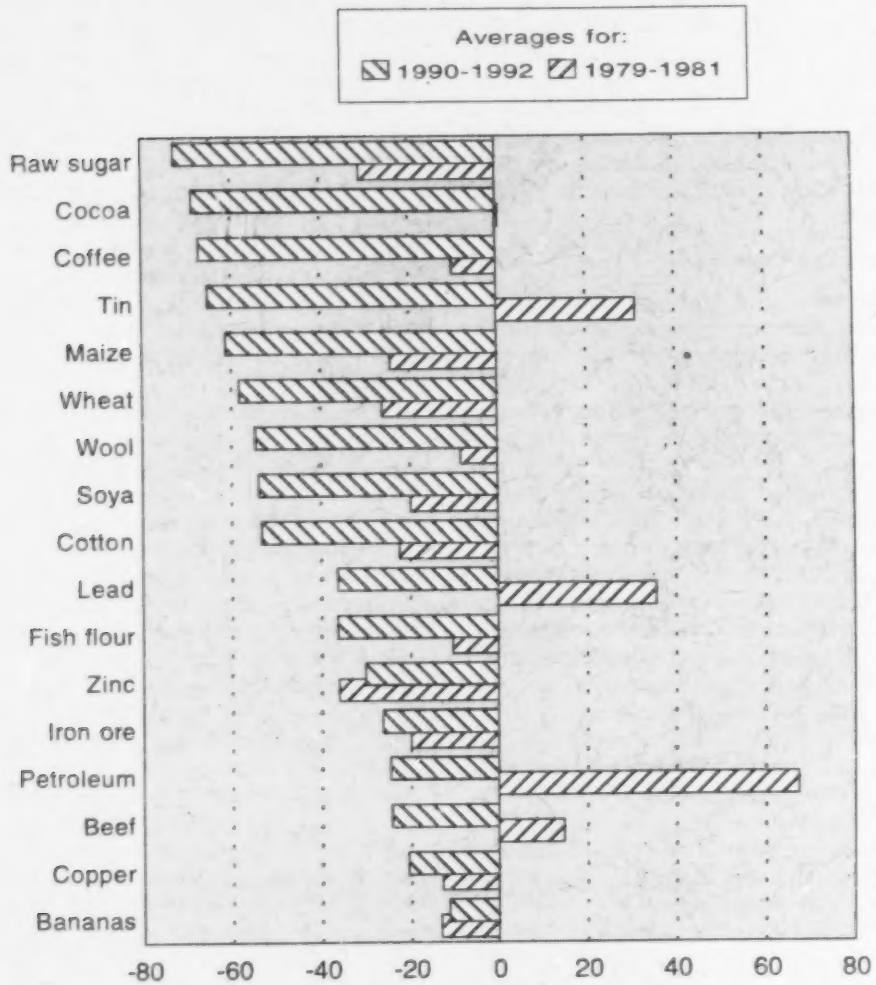
17 It is important to make clear that the conventional distinction between fresh and unprocessed fruit and vegetables does not necessarily mean a lesser incorporation of added value. Often fresh produce requires fairly complex processes of production, harvesting, selection, classification, quality control, conservation and transportation. On the other hand, the markets of final consumption of these products tend to be very demanding as regards their quality and presentation. There is a whole range of ancillary services in the production process that increases the added value (ECLAC, 1993a).

18 We take "non-traditional exports of basic products" to cover those in which the product is not included in the Integrated Programme on Commodities of UNCTAD; does not belong to the energy group; is a new phenomenon for the country in question; involves a new market for the product; may appear outside the traditional season; and is of a certain sectoral importance in the national economy (ECLAC, 1992d).

Figure III.3

LATIN AMERICA AND THE CARIBBEAN: REAL PRICES OF EXPORT PRODUCTS[a]

(Percentage variations with respect to the average for 1975 and 1976)



Source: ECLAC, on the basis of official data.

[a] The nominal prices were deflated by the unit value index of exports of manufactures from the developed market-economy countries.

ma); soluble flours and similar food for animals derived from marine species (Chile and Ecuador); frozen shrimp (Ecuador); salmon (Chile); grapes (Chile and Mexico); apples (Chile); pineapples (Costa Rica and Dominican Republic); concentrated orange juice (Brazil); fresh chicken meat (Mexico); cut flowers (Colombia and Costa Rica); and sawn wood and cross-ties (Chile). In all these cases, during the period 1970-1990, the export growth of these countries exceeded by a substantial margin the average rate of increase of world exports of the product in question (ECLAC, 1992d).

b) Industrial exports

Between 1980 and 1991, the value of industrial exports (semi-manufactures and manufactures) from the region rose by 7% a year. In the case of Mexico and Chile, the increments were 17% and 10% per year, respectively; in Argentina 7%; in Brazil 6%.

The biggest surge of exports in this period, for the region as a whole, was achieved in the basic-input industries (17% a year). They doubled the average increase of the traditional and new industries, both labour- and capital-intensive. Semi-manufactures expanded more slowly (2% a year)[19] (see table III.5). Mexico stands out as having the most dynamic industrial exports and also for having achieved the most balanced growth among its different types of industry. In Chile, the greatest export surge took place in the traditional industries, while in Brazil and Argentina the expansion was led by the basic-input industries.

The strong and accelerated growth of basic-input manufactured exports is based on three factors: i) it is the industrial activity which achieved the highest increase in productivity in the 1980s (3% a year, almost double the general increase in manufacturing productivity in this period); ii) the fall in domestic demand encouraged foreign sales because, this being a capital-intensive production process, its variable costs, regardless of the exchange rate, tend to be much lower than its average costs; and iii) its products are intermediate goods based on natural resources, which are relatively homogenous "industrial commodities" and easier to sell on world markets.

The reasonable buoyancy of industrial exports from the region during the 1980s i) occurred in a context of meagre growth of industrial production (1.1% a year, as opposed to an annual average of 6.4% in the 1970s); and ii) in nearly all cases, led to an increase in the share of manufactures in total exports.

As a consequence of this latter process, in 1992, in two economies —Brazil and Mexico— manufactures accounted for close to a half of total exports. In two others, El Salvador and Uruguay, the levels exceeded one third of the total.[20] Argentina, Colombia, Costa Rica and Guatemala exported manufactures amounting to more than 20% of their total exports. On the other hand, in natural resource-intensive countries such as Chile, Ecuador or Venezuela, manufactures exports were below a tenth of the total (see table III.6).

As regards the technological content of manufactures exports, traditional industries predominated in Bolivia, Colombia, Costa Rica, El Salvador, Paraguay, Peru and Uruguay. In the cases of Nicaragua and Venezuela industrial exports of basic inputs are the most important. In Argentina, Brazil, Chile, Ecuador, Guatemala, Honduras and Mexico exports from

19 We take manufactured goods to mean those included in sections 6, 7 and 8 of the SITC, except for those included in chapter 68. In the rest of this chapter, we shall differentiate between semi-manufactures, traditional industries, basic inputs, new labour-intensive industries and new capital-intensive industries. A more detailed explanation of this classification may be found in ECLAC (1992e), pp. 30-34.

20 El Salvador's exports were primarily medical supplies to Central America, together with textiles and manufactures of paper and cardboard; Uruguay's were mainly textiles and hides.

Table III.5
LATIN AMERICA AND THE CARIBBEAN: INDUSTRIAL EXPORTS BY TECHNOLOGICAL CONTENT, 1980-1991
(Annual average growth rates)

	Total	Semi-manufactures[a]	Traditional industries[b]	Basic input industries[c]	New labour-intensive industries[d]	New capital-intensive industries[e]
Argentina	7.1	6.4	7.8	16.1	-0.4	5.5
Brazil	5.9	1.7	3.6	22.3	0.7	6.9
Chile	9.6	9.1	20.4	9.5	10.9	9.6
Mexico	17.3	8.9	20.6	27.5	23.2	8.6
Other countries[f]	0.7	-3.5	5.3	10.8	6.4	12.1
Latin America and the Caribbean	7.1	2.2	7.8	16.9	7.7	7.7

Source: ECLAC, on the basis of UNIDO data, and, in the case of Chile, on data from the National Institute of Statistics.
[a] Foodstuffs, beverages, tobacco, wood and wood products, paper and paper products, industrial chemicals, petroleum refineries and petroleum and coal products (ISIC groupings 311, 313, 314, 331, 341, 351, 353, 354). [b] Textiles, wearing apparel, leather and leather products, footwear, rubber products, ceramic products, glass and glass poducts, and miscellaneous manufactures (ISIC groupings 321, 322, 323, 324, 355, 361, 362, 390). [c] Plastic products, other non-metallic mineral products, iron and steel, and non-ferrous metals (ISIC groupings 356, 369, 371, 372).
[d] Furniture, printing and publishing, non-electrical and electrical machinery (ISIC groupings 332, 342, 382, 383).
[e] Pharmaceuticals and other chemical products, metal products, transport equipment, and professional and scientific equipment (ISIC groupings 352, 381, 384, 385). [f] Includes Barbados, Bolivia, Colombia, Costa Rica, Dominican Republic, Ecuador, Guatemala, El Salvador, Jamaica, Uruguay and Venezuela.

new industries were dominant, although within the total of manufactures exports their share varied widely (see table III.6).

The diversity of the manufactures exports of the region, from the standpoint of productive and technological levels, is clear from the fact that, in 1992, Brazil and Mexico accounted for 77% of the regional total. Manufactures exports from these countries, plus those from Argentina, Colombia and Venezuela, represent 90% of the total. Also, the relative weight of Brazil and Mexico increases with the growing technological complexity of the goods; the two countries accounted for 60% of traditional exports, 77% of exports of basic inputs and 85% of regional exports of new industrial products.

Together with the increase in industrial exports during the 1980s, the region boosted its share in the manufactured imports of the Organisation for Economic Cooperation and Development (OECD) countries from about 2.7% in 1980 to 3.7% in 1990.[21] To the extent that OECD may be considered the most demanding and competitive market in the world as regards price and quality, the fact that the region increased its share of the market indicates that it has achieved advances in industrial competitiveness. The region's participation increased as regards both traditional manufactures and basic-input industries. However, the region's increased share in new manufactured imports of low, medium and high technological content was limited essentially to Mexico.

c) Services

Services constitute a fifth of world trade in goods and services. In 1991 their level of exports was US$ 890 billion. In the

21 Calculated by Joint ECLAC/UNIDO Industrial and Technological Development Unit, using version 1.1 of the Competitive Analysis of Nations (CAN) software.

Table III.6

LATIN AMERICA (16 COUNTRIES): COMPOSITION OF MANUFACTURES EXPORTS (1970, 1980, 1990-1992)

(In percentages and in millions of dollars)

		Traditional industries	Basic inputs	New industries	Total	Manufactures exports (current dollars)	Manufactures as % of exported goods
Argentina	1970	25.9	16.8	57.3	100.0	232	13.1
	1980	36.7	12.5	50.7	100.0	1 645	20.5
	1992	28.4	22.2	49.4	100.0	2 892	23.6
Bolivia	1970	4.6	94.8	0.6	100.0	13	5.8
	1980	24.4	1.5	74.2	100.0	23	2.2
	1992	66.0	0.5	33.5	100.0	86	11.2
Brazil	1970	21.8	36.9	41.7	100.0	312	11.5
	1980	23.6	17.4	58.9	100.0	6 740	33.6
	1992	21.8	29.0	49.2	100.0	18 247	50.7
Colombia	1970	52.9	15.9	31.2	100.0	48	6.6
	1980	54.4	10.4	35.2	100.0	636	16.1
	1992	50.8	20.4	28.8	100.0	1 878	27.2
Costa Rica	1970	34.9	14.4	50.7	100.0	37	16.1
	1980	40.9	13.8	45.3	100.0	253	26.1
	1991	42.2	16.3	41.6	100.0	346	21.2
Chile	1970	0.6	29.6	69.7	100.0	27	2.2
	1980	6.4	40.0	53.6	100.0	241	5.3
	1992	30.3	17.6	52.1	100.0	733	7.4
Ecuador	1970	47.3	0.2	52.5	100.0	3	1.6
	1980	36.5	1.9	61.7	100.0	54	2.2
	1992	40.8	7.2	52.0	100.0	87	3.0
El Salvador	1970	57.6	9.7	32.7	100.0	57	25.2
	1980	57.5	9.9	32.6	100.0	219	30.5
	1991	54.3	7.1	38.5	100.0	125	34.3
Guatemala	1970	49.9	12.9	37.2	100.0	76	26.3
	1980	41.4	10.8	47.8	100.0	326	22.0
	1992	37.4	15.9	46.7	100.0	354	26.9
Honduras	1970	56.0	4.2	39.8	100.0	12	6.8
	1980	35.0	4.4	60.5	100.0	76	9.3
	1992	40.3	7.4	52.3	100.0	78	10.6
Mexico	1970	22.4	11.0	66.3	100.0	326	27.8
	1980	22.5	6.7	70.7	100.0	1 469	9.5
	1992	10.4	11.4	78.3	100.0	12 966	47.6
Nicaragua	1970	45.4	19.7	34.9	100.0	24	13.7
	1980	27.6	45.2	27.2	100.0	46	11.2
	1991	22.5	48.9	28.5	100.0	19	7.2
Paraguay	1970	4.1	7.6	88.3	100.0	5	7.1
	1980	24.7	0.0	75.2	100.0	19	6.1
	1992	64.2	10.9	24.9	100.0	85	12.9
Peru	1970	36.1	36.1	27.8	100.0	11	1.0
	1980	60.9	12.1	27.0	100.0	494	14.7
	1990	75.1	2.4	22.5	100.0	570	17.2
Uruguay	1970	76.9	11.8	11.3	100.0	40	17.4
	1980	71.1	10.3	18.5	100.0	377	35.6
	1992	72.0	7.6	20.5	100.0	622	38.4
Venezuela	1970	4.7	77.2	18.0	100.0	23	0.7
	1980	2.7	59.3	38.0	100.0	216	1.1
	1992	11.7	52.6	35.7	100.0	1 221	8.7

Source: ECLAC, on the basis of official data. Manufactures exports have been classified in accordance with the criterion discussed in ECLAC, "El comercio de manufacturas en América Latina, evolución y estructura, 1962-1989", Estudios e informes de la CEPAL series, No. 88 (LC/G.1731-I), Santiago, Chile, November 1992, pp. 30-34.

biennium 1990-1991 the value of commercial services[22] increased by 12.5%, as opposed to 7.5% in merchandise trade (GATT 1993b). In the period 1970-1991 commercial services increased at a yearly rate of 13%. The main items were transport and travel, but the most buoyant ones were other private services.[23]

The countries of the Group of Seven (G-7) accumulated 52% of world exports of services, the newly industrializing Asian economies 6%; only 2.5% of the world total came from the six Latin American countries which reached a level where they could be included among the 50 main suppliers of services: Mexico (1.4% of world exports); Brazil (0.4%); Chile, Argentina and Colombia (0.2% each); and the Dominican Republic (0.1%) (GATT, 1993b).

Regional exports of services increased at an annual average rate of 10.6% between 1985 and 1992. This meant that, in seven years, services exports rose from 15% to 21% of regional exports of goods and services (see table III.7).

4. Diversification of exports and patterns of specialization

As a result of the search for new markets by producers, favourable exchange rates, the application of promotion policies designed to extend and diversify the supply of tradables, and the conclusion of trade agreements, the structure and destination of regional exports have been considerably modified.

A number of Latin American and Caribbean countries succeeded in reducing the concentration of their exports on a few products. In 1970, the region's 10 main export products represented 56% of the total value of exports. In 1990, the proportion had fallen to 40%.[24] Over this period, the reduction in the relative weight of the 10 main export products was very substantial in Brazil, Uruguay, Chile, Colombia, Costa Rica and Peru (between 21 and 31 percentage points). In Brazil it was only 37% in 1991, as against 68% in 1970. More moderate reductions were observed in Bolivia, Argentina and El Salvador. On the other hand, in a number of countries the share of the main products in the export total remained the same. In some countries, even (Mexico, Nicaragua, Paraguay), this share increased.[25] Thus, while in 1980 in 15 countries the 10 main export products brought in two thirds or more of their export earnings, in 1991 this ratio was to be found only in seven of them (Bolivia, Ecuador, Honduras, Nicaragua, Paraguay, Trinidad and Tobago and Venezuela) (ECLAC, 1993b).

a) Changes in the patterns of specialization

In the last two decades the countries of Latin America and the Caribbean have seen important changes in patterns of specialization. In a large group of countries (Argentina, Brazil, El Salvador, Guatemala, Mexico, Uruguay and Venezuela) the share of primary commodities in exports fell sharply while that of semi-manufactures and manufactures rose. In Colombia and Peru, the reduction in the relative share of primary exports occurred only in favour of manufactures exports. In a third group (Bolivia, Chile, Ecuador, Honduras and Paraguay) the relative weight of primary exports increased, to the detriment of the share of exported semi-manufactures, and there was an in-

22 There is no international agreement on the definition of services which are traded. By "commercial services" GATT means those of transport, travel and other services and rents in the private sector (see GATT (1993c), p. 68).

23 Including insurance, commissions and brokerage, construction and engineering, communications, consulting, marketing, advisory services and banking.

24 By contrast with 1970, they also include two industrial products with a high technological content: automotive vehicles (2.3% of total exports) and internal combustion engines (2.1%).

25 In Mexico, this increase was due to the incorporation of oil exports, which boosted the share of the 10 main products in 1970-1990. Later it fell again.

Table III.7
LATIN AMERICA (19 COUNTRIES): EXPORTS OF GOODS AND SERVICES
(Millions of dollars at current values)

	1980	1985	1990	1992
A. Goods	88.5	92.0	121.8	127.0
B. Services	16.3	16.6	28.7	33.7
C. Total exports	104.9	108.5	150.5	160.8
(B/C)*100 [a]	**15.5%**	**15.3%**	**19.0%**	**21%**

Source: ECLAC, on the basis of official data.
[a] Percentage of total exports corresponding to services.

crease in the relatively low share of exported manufactures (see table III.8).

Most of the countries which changed their patterns of specialization in favour of manufactures and to the detriment of primary commodities or semi-manufactures registered, over the two decades, smaller declines in the real prices of their exports[26] than the countries where this did not occur. This trend strengthens the hypothesis that the acquisition of competitive advantages in the manufacturing sector improves linkages with the international economy.

Of the countries with the best export drive in the 1980s, Brazil, Colombia and Mexico achieved this position by reorienting their export profiles towards industrial products. Costa Rica also reduced the share of primary commodities in its supply of exportable goods and increased the proportion of manufactures and other goods. Chile, Ecuador and Paraguay based their sound export performance mainly on the strengthening of the primary component, although with processes of diversification of products and markets (see tables III.3 and III.8).

Furthermore, confirming the strategic association between industrial exports and development, in the period 1985-1992 the six countries with the highest GDP growth revealed more rapid rates of expansion of exports of manufactures (Chile, Venezuela and Colombia) or of semi-manufactures (Costa Rica, Uruguay, Paraguay) (see table III.4).

Within world trade in manufactures, new industries enjoy a comparatively greater dynamism. In this respect, there is a marked contrast between different countries. Brazil and Mexico recorded substantial increases in the export of this type of product, which have come to represent 25% and 37%, respectively, of their goods exports. Argentina, Costa Rica, Guatemala, El Salvador and Uruguay reached an intermediate position, where the products of the new industries represent between 8% and 13% of total exports. On the other hand, Venezuela, Paraguay, Chile, Ecuador and Bolivia show values which are still a very small part of their total exports in this category (see table III.6).

A review of the commercial impact of the pattern of export specialization reveals the persistence of trade surpluses in primary commodities which help to finance the net deficit in the industrial sector. Brazil is the exception. It has deficits in primary commodities and surplus balances in the other sectors, except new industries (see table III.9). Brazil also has a trade surplus in agricultural and mining pro-

26 Defined as the ratio between the unit value of the goods exports of the country and the unit value of the manufactures exports of the developed countries.

Table III.8
LATIN AMERICA (16 COUNTRIES): COMPOSITION OF GOODS EXPORTS
(1970, 1980, 1990-1992)
(In percentages)

		Primary commodities	Semi-manufactures	Manu-factures	Other	Total
Argentina	1970	61.3	25.6	13.1	0.1	100.0
	1980	48.9	30.6	20.5	0.0	100.0
	1992	36.9	39.4	23.6	0.1	100.0
Bolivia	1970	48.4	45.8	5.8	0.1	100.0
	1980	61.3	36.5	2.2	0.0	100.0
	1992	58.7	29.6	11.2	0.4	100.0
Brazil	1970	67.0	21.2	11.5	0.3	100.0
	1980	30.2	36.0	33.6	0.2	100.0
	1992	19.1	29.1	50.7	1.1	100.0
Colombia	1970	85.1	7.7	6.6	0.6	100.0
	1980	70.3	11.3	16.1	2.3	100.0
	1992	58.9	11.2	27.2	2.7	100.0
Costa Rica	1970	72.0	11.9	16.1	0.0	100.0
	1980	60.2	13.7	26.1	0.0	100.0
	1991	58.1	11.3	21.2	9.4	100.0
Chile	1970	12.9	84.9	2.2	0.0	100.0
	1980	20.2	74.4	5.3	0.1	100.0
	1992	31.2	57.0	7.4	4.4	100.0
Ecuador	1970	90.5	7.9	1.6	0.0	100.0
	1980	74.3	23.5	2.2	0.0	100.0
	1992	90.1	6.7	3.0	0.2	100.0
El Salvador	1970	63.2	11.4	25.2	0.2	100.0
	1980	54.2	15.0	30.5	0.3	100.0
	1991	45.5	20.0	34.3	0.1	100.0
Guatemala	1970	60.1	13.5	26.3	0.1	100.0
	1980	60.2	17.6	22.0	0.2	100.0
	1992	47.6	25.3	26.9	0.2	100.0
Honduras	1970	75.0	18.2	6.8	0.0	100.0
	1980	77.8	12.8	9.3	0.0	100.0
	1992	81.1	7.6	10.6	0.7	100.0
Mexico	1970	45.3	26.7	27.7	0.3	100.0
	1980	80.7	9.7	9.5	0.1	100.0
	1992	38.2	13.5	47.6	0.6	100.0
Nicaragua	1970	68.3	18.0	13.7	0.1	100.0
	1980	73.1	15.7	11.2	0.0	100.0
	1991	68.4	21.3	7.2	3.1	100.0
Paraguay	1970	43.7	49.2	7.1	0.0	100.0
	1980	56.7	37.2	6.1	0.0	100.0
	1992	61.0	26.1	12.9	0.0	100.0
Peru	1970	30.5	68.4	1.0	0.0	100.0
	1980	44.9	40.3	14.7	0.1	100.0
	1990	28.9	53.9	17.2	0.0	100.0
Uruguay	1970	61.6	20.9	17.4	0.1	100.0
	1980	39.8	24.5	35.6	0.1	100.0
	1992	28.6	32.5	38.4	0.5	100.0
Venezuela	1970	70.0	29.0	0.7	0.2	100.0
	1980	66.6	32.2	1.1	0.0	100.0
	1992	53.3	37.7	8.7	0.2	100.0

Source: ECLAC, on the basis of official data. Goods exports have been classified in accordance with the criterion discussed in ECLAC, "El comercio de manufacturas en América Latina, evolución y estructura, 1962-1989", Estudios e informes de la CEPAL series, No. 88 (LC/G.1731-P), Santiago Chile, November 1992, pp. 30-34.

Table III.9
LATIN AMERICA (FIVE COUNTRIES): TRADE BALANCE AND PATTERN OF SPECIALIZATION
(Trade balance sign, by type of product)

	Primary	Industrial	Semi-manufactures	Manufactures	Traditional	Basic inputs	New industries
Argentina	+	-	+	-	+	-	-
Brazil	-	+	+	+	+	+	-
Colombia	+	-	-	-	+	-	-
Chile	+	+	+	-	-	-	-
Mexico	+	-	-	-	0	-	-

Source: ECLAC, on the basis of official information. The trade balance sign is the average for the period 1980-1992, in 1985 dollars.

ducts, but its deficit in energy products is greater than the two surpluses. Between 1983 and 1990, Chile had a favourable trade balance in industrial products. This was because the surplus in semi-manufactures, especially those based on mining resources, exceeded the deficit in manufactures.

Of the countries with a trade deficit in industrial products, Colombia and Mexico show a deficit in manufactures and semi-manufactures; Argentina and Chile, only in manufactures. Under the heading of manufactures exports, Argentina, Brazil and Colombia are net exporters of traditional industrial products and Brazil is also a net exporter of basic inputs. Under the heading of new industries, all the countries considered here are net importers. However, since the mid-1980s Brazil has became a net exporter of products of new capital-intensive industries.

b) Diversification of products and markets

A comparison of the present composition of exports by technological categories and destinations[27] with the export structure in the early 1970s revealed significant changes in the export specialization of the countries of the region *vis-à-vis* the different markets (see table III.10).

i) In the region's exports to the United States, primary commodities were reduced and mining products almost disappeared. This change was accompanied by an increase in the primary exports of energy products. Semi-manufactures fell off sharply and the share of manufactures almost tripled. This is explained by the rise in exports of new industrial products, both labour- and capital-intensive.

ii) In the case of Europe, the share of primary commodities, especially agricultural, declined. Meanwhile, the share of manufactures rose. Among these, the increase in the importance of new industries (mostly those with medium technological content) was clear: they represented from 2.2% to 10.4% of the total exported from the region to Europe.

iii) In exports to Japan the relative weight of primary exports also declined, from a little under 50% in 1992, because of the fall in exports of agricultural and mining products and the considerable rise in the share of energy products. The corresponding rise in industrial exports was due in this case to the expansion of semi-manufactures based on mining resources

27 For the purpose of this analysis, five destinations were defined: United States, Japan, Europe (EEC and EFTA), Latin America and the Caribbean and other regions.

Table III.10

LATIN AMERICA (12 COUNTRIES):[a] COMPOSITION OF EXPORTS BY DESTINATION, 1970-1974 AND 1992

(In percentages)

	United States		Japan		Latin America and the Caribbean		EEC and EFTA		Total	
	1970-1974	1992	1970-1974	1992	1970-1974	1992	1970-1974	1992	1970-1974	1992
A. Primary commodities	47.7	39.9	65.0	48.5	52.6	25.4	60.8	44.0	54.7	36.4
1. Agricultural products	25.3	14.3	39.5	17.6	11.6	9.6	48.2	26.3	30.3	16.2
2. Mining products	5.9	0.9	25.3	19.5	0.9	1.5	6.2	6.7	5.4	4.2
3. Energy products	16.4	24.7	2.2	11.4	40.1	14.3	6.4	10.9	18.9	16.0
B. Industrialized products	51.9	59.2	32.8	50.2	47.2	74.3	38.8	55.1	44.9	62.5
1. Semi-manufactures	38.4	21.8	27.1	37.4	22.2	24.2	31.9	34.6	32.0	28.2
1.1 Based on agricultural resources and labour-intensive	5.7	5.1	3.1	8.0	6.9	7.7	14.1	17.6	8.7	10.2
1.2 Based on agricultural resources and capital-intensive	7.4	1.7	7.2	6.8	3.1	3.6	2.7	4.9	5.7	4.0
1.3 Based on mineral resources	4.5	5.9	15.9	22.4	5.7	7.2	13.2	10.7	8.0	8.6
1.4 Based on energy resources	20.8	9.1	0.9	0.2	6.5	5.7	1.9	1.5	9.6	5.4
2. Manufactured goods	13.5	37.4	5.7	12.7	25.0	50.1	6.8	20.5	12.9	34.3
2.1 Traditional industries	5.4	8.4	2.3	1.3	4.5	8.3	3.8	6.2	4.5	7.2
2.2 Basic-input industries	1.8	4.6	1.3	6.0	4.7	10.9	0.8	3.9	2.0	7.6
2.3 New labour-intensive industries	4.2	11.3	1.7	4.3	8.7	13.3	1.1	6.1	3.8	9.4
a) Low technological content	0.5	1.3	0.1	2.4	1.6	2.1	0.2	0.6	0.6	1.3
b) Medium technological content	1.8	5.9	0.2	0.4	4.2	6.9	0.4	4.1	1.7	5.0
c) High technological content	2.0	4.1	1.4	1.5	2.9	4.3	0.4	1.4	1.5	3.1
2.4 New capital-intensive industries	2.2	13.0	0.4	1.1	7.1	17.6	1.1	4.3	2.7	10.2
a) Low technological content	0.3	0.5	0.0	0.4	0.6	1.1	0.0	0.2	0.3	0.5
b) Medium technological content	1.4	10.8	0.3	0.5	5.0	14.8	0.6	3.1	1.8	8.4
c) High technological content	0.4	1.7	0.1	0.1	1.4	1.7	0.5	1.1	0.6	1.3
Other	0.4	0.9	2.2	1.3	0.2	0.3	0.4	1.0	0.4	1.1
Total	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**	**100**

Source: ECLAC, on the basis of official data.

[a] Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Guatemala, Honduras, Mexico, Paraguay, Uruguay and Venezuela.

and of basic-input industries. New industries increased only marginally their share in regional exports to Japan.

iv) The profile of intraregional exports reveals a drastic change: the predominance of primary exports was replaced by the predominance of industrialized products, which now account for three quarters of the trade between the countries of the region. A quarter of this trade is in semi-manufactures, which have barely changed their relative importance. This notable increase in industrial exports is made up of manufactured goods (now half of the total), especially from basic-input industries and new industries which are labour-intensive and especially capital-intensive.

v) Exports within the region show a clear industrial bias, with emphasis on new industries, and a bias in primary and semi-manufactures exports to Japan and Europe, although with greater emphasis on new industries in the European market. Of the major industrialized markets, the United States is the one which accords the greatest welcome to new industries.

The diversification of products and markets has assumed different forms within the region. Brazil, and to a lesser extent, Uruguay and Colombia, have achieved the highest degree of diversification. They have substantially reduced the share of their 10 principal products in the total. They have increased the number and importance of different raw materials and semi-manufactures, successively incorporating various types of manufactures and diversifying the regional destinations of their exports. Mexico concentrated on one destination (the United States) but diversified its exports, especially manufactures, by incorporating new products. Argentina's diversification has been somewhat erratic, as a result of political changes and the recessions of the 1980s. Nevertheless, and less intensively than Brazil and Mexico, it has tried to incorporate manufactures and to diversify its supply of raw materials and semi-manufactures and the destinations of its exports. Chile and Peru concentrated on sales of primary commodities and semi-manufactures but diversified the destinations of their exports. Chile boosted its manufactures exports, although from a reduced base, and diversified exports of raw materials and semi-manufactures. Peru, without modifying the essential features of its specialization, incorporated a number of manufactures exports. Exports from Ecuador, Bolivia and Paraguay were still concentrated on a few primary products and were channelled towards one big market: the United States for Ecuador, Latin America for the other two countries. The concentration of products and markets is somewhat less in the case of Guatemala, but continues to be important.

As regards export diversification by products and destinations, Mexico is a special case: basically, all its exports go to the United States. In the other cases, Europe continues to be important as a market for the region's primary commodities and semi-manufactures. While the relative weight of this market has been reduced (partly as a result of a diversification of exported products which, in the case of the bigger countries, lowered the share of primary commodities), it continues to be the principal one and absorbs more than 30% of the exports of Argentina, Brazil, Chile and Paraguay and close to that percentage in Bolivia, Colombia and Uruguay.

The United States is the main buyer of Latin American fuels and petrochemicals. Europe and Japan are supplied mainly from the Middle East and Africa. Latin America is important as a market for natural gas (Bolivia and Argentina).

Latin America and the Caribbean are very important, and dynamic markets for the sales of manufactures. For Colombia, Chile and Ecuador this is by far the biggest market, be it for traditional industries, basic inputs or new industries. This concentration is not so marked in the cases of Argentina, Paraguay and Uruguay. They have a considerable diversification of markets for their traditional industries and, in Argentina, also for the basic-input industry. However, Latin America has been and continues to be the almost exclusive desti-

nation for exports from the new industries of these countries. The same is true of the subregional market as regards the new industries of Costa Rica and Guatemala. Brazil has channelled its export manufactures to different markets. The United States continues to be the main buyer of traditional products, followed by Europe. As for basic inputs, other developing regions have displaced Latin America as the main destination, but in the case of new industries, the region is the most important market; an exception is the case of Mexico, where the regional market has less relative importance than the United States.[28]

5. Intraregional trade and technological intensity

Development based on a growing and sustained international competitiveness is boosted by the dynamic effects derived from the processes of technological apprenticeship. The strategies to improve international linkages based on productive development emphasize the role played by trade in the process of stimulating the development of activities which make intensive use of knowledge and technology. In this sense, it is a common belief that trade among developing countries is characterized by concentrating on goods that are more technology-intensive than those traded between developing and industrial countries.

Studies based exclusively on foreign trade data (ECLAC, 1992e; Barbera, 1990) confirm this argument. It is also corroborated in a recent ECLAC study (Buitelaar, 1993a) which combines foreign trade data and production data. The figures show that products which encounter a relatively important component of their demand on the regional market are precisely those with more complex technological characteristics than those channelled towards extraregional or domestic markets.[29]

From the research carried out, three main conclusions emerge:

a) The production of goods which depend to a greater extent than others on intraregional trade has more sophisticated technological features. Such goods are to be found mainly in the chemical sector, non-electrical machinery and transport equipment. They are also sectors in which international demand tends to be more dynamic. Their price trends are more stable and more positive over the long term.

b) The sectors which show a strong export drive towards the region also show a similar drive towards extraregional markets, which suggests that the promotion of intraregional trade complements the promotion of extraregional exports.

c) These same sectors are those in which the region has a high dependency as regards extraregional imports, and therefore intraregional trade in them benefits from having access to inputs and equipment which may be imported from third countries.

To sum up, intraregional trade, precisely because of its different characteristics, associated with closeness and the contacts of all types which facilitate such trade, complement the region's linkages with the global economy and provide a dynamic context of technological apprenticeship, leading to greater international competitiveness and a more diversified, balanced pattern of specialization in the world economy.

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28 Regressions carried out for the period 1970-1991 show that there was a strong positive relationship between the importance of Latin America as a destination and the share of new-industry exports in the total exports of Argentina, a relationship that is positive but less intense for Brazil. In Chile, the exercise revealed a strong positive correlation for all the manufactures. For Mexico, however, no significant relationship was obtained.

29 For a complete investigation of this argument, see ECLAC (1994a).

Chapter IV

EXPORTS AND CHANGING PRODUCTION PATTERNS

1. Exports and growth

In the present international context, an increasing ability to compete and more dynamic linkages with world markets have become essential for sustained growth. In the framework of the proposal put forward by ECLAC (ECLAC, 1990a; 1992a), several conditions are necessary for successfully changing production patterns as an impetus to growth. First, a change in relative prices that favours the production of exportables and the equilibrium of the export sector; a real exchange rate that depreciates *pari passu* with the gradual reduction of protection against imports, incentives and drawbacks for exporters; and safeguard mechanisms to offset unfair competition from external suppliers. Second, a macroeconomic environment favourable to investment and technological innovation; among other requisites, this presupposes a level of economic activity close to the production frontier and "reasonable" real interest rates which are compatible with the profitability of productive capital. Third, an endowment of production factors which is capable of responding to the demand from producers of exportables and efficient producers of import substitutes. Many of these factors come from markets that are currently imperfect, incomplete or non-existent. Therefore, what is needed is an active, efficient policy of government support so that liberalization will lead to self-sustained growth, which includes improving or creating the markets or institutions needed to steadily enhance productivity.

At least three ways can be distinguished in which exports can help to increase a country's economic growth rate.[30]

The first is the role which export earnings play in generating foreign exchange, making it possible to acquire the imports that every country needs to fuel its economic expansion.[31]

Only a good export performance can ensure a sustainable supply of foreign exchange over the medium and long term. This entails promoting exports, but bearing in mind that this is not just a question of volume but also of price: what is import-

30 A great number of econometric studies have tried to find a statistical link between export growth and output. A survey of these studies yields no definitive conclusions as to the exact role played by exports in the growth process. Rather, they show a complex link that does not operate in the same way or in the same terms in all cases. Results depend, decisively, on the quality of public policies and the external environment.

31 Given the heavy dependence of developing countries on imported machinery and equipment, the availability of foreign exchange can also considerably affect the investment rate (Taylor, 1988; Díaz-Alejandro, 1976).

ant from the standpoint of generating foreign exchange is not only the volume of exports but also the return obtained from them. Thus, it is important to promote exports of goods and services whose prices (by unit of inputs) are likely to rise, rather than fall, over time.

It is also important to reduce fluctuations in the supply of foreign exchange, in order to avoid the repercussions that the cyclical nature of international goods markets can have on domestic activity. In this regard, a number of instruments designed to mitigate abrupt fluctuations have been used in recent years to supplement traditional policies aimed at diversifying the basket of export goods and target markets. These new instruments include stabilization funds for products that produce a high percentage of export earnings and incipient futures markets (see chapter II).

The second way in which exports influence development is through so-called "linkages". In a ground-breaking study, Hirschman (1978) identified "backward" and "forward" production linkages. A backward linkage involves the possibility that the development of a particular activity might lead to the emergence or expansion of local suppliers of inputs and capital goods for that activity (for example, the development of canned fruit exports can stimulate the expansion of tin can manufacturing, or the installation of an automotive plant can lead to the development of an automotive parts industry). A forward linkage, on the other hand, involves the possibility of increasing the degree of processing or incorporating more added value in an existing production line (for example, wood pulp production based on the availability of forestry resources).

Obviously, the more highly processed the exports and the more integrated the production chain, the greater the dynamism of the economic activity generated by foreign sales. In this sense, the contribution that exports make to growth will depend on the level of development of the economy's production structures. It is important in this regard to emphasize that linkages represent a potential whose realization is by no means guaranteed. This is where public policy is important —not to establish such linkages artificially, but to provide the technology, training and infrastructure needed to facilitate that process.

Besides production linkages, there are other effects as regards the impact on consumption and fiscal revenues. Thus, the more labour-intensive the export activity (considering the direct and indirect employment created) and the better distributed the income generated within and among firms, the greater the effect on domestic demand. Tax policy can also help to increase the side-effects when exports produce high economic rents. This obviously depends, however, on what the Government does with the revenues obtained.

The third way in which exports can affect the growth rate has been highlighted by recent ECLAC studies. Given their greater contact with the international economy and the pressures they face to be competitive, export activities can not only lead to a more efficient utilization of available resources but also help raise productivity in other areas of the economy. As shown by some studies on the performance of firms in the region, enterprises that export tend to be more innovative than average as regards both technology and management (Guerguil, Macario and Peres, 1993). Although no similar studies have been made of the impact of the experience of export firms on activities geared to the domestic market, certain suggestions can be made as to how that influence might be increased.

Clearly, the more export firms and export-producing sectors there are, the greater their impact. The number of contacts between exporters and domestic producers increases, and there are more opportunities to share information, designs, management methods, etc. This kind of feedback can take place through explicit channels (such as links with suppliers and agreements with subcontractors) or through more informal channels such as personnel movements and demonstration effects. On the other hand, the more export activity is limited to a few

products and producers, with few links to other areas of the economy, and the more it becomes like an "enclave", the more limited its impact is likely to be.

The impact will be proportionately greater when the capacity of the country to absorb the lessons learned by export firms is greater. Innovations will be more easily adopted and stimulated if there are mechanisms to expedite technology transfer, if the educational level of the workforce is high, if there are functioning systems for training and retraining personnel, if business associations are active in promoting exchanges of information and knowledge among their members, in short, if there is an institutional framework which stimulates adaptation and innovation among firms, whether or not they are exporters.

In some cases, export activities are carried out by transnational corporations, which tend to adopt innovations more easily but may have less incentive to pass them on to others. In some countries (the Republic of Korea is a good example), access to foreign investment is tied to technology transfer agreements (Anglade and Fortin, 1987). Even though the basic concern in many Latin American and Caribbean countries today is simply to attract investments, they should still explore ways of encouraging the firms that come into the region to transfer more innovations.

In sum, there are many reasons why a country should increase its exports. In general, exports are the main source of foreign exchange, which is essential for financing imports. Through linkages, exports can also help activate material and human resources that are available but underutilized because of a lack of demand. Also, resources are likely to be more productive if they are used for export activities, since installed capacity can be used more intensively, economies of scale are easier to achieve (particularly in small countries), and rapid access to imported inputs and external competition lead to greater efficiency and more rapid adoption of innovations. In addition, exports can generate positive externalities for the rest of the economy by demonstrating the benefits to be obtained from the more sophisticated practices used by export firms; by moving to other sectors of the economy managers and employees who understand the demands of international competitiveness; and by the actual demands which export firms make on their domestic suppliers in terms of quality and ability to met deadlines. Lastly, various authors have pointed out that further external liberalization would also have the advantage of promoting more efficient management of overall economic policy (Krueger, 1980; Mussa, 1987). This is because the more linkages there were between the domestic economy and the international economy, the greater the costs would be of introducing severe market distortions or making mistakes in macroeconomic management.

These various ways in which exports can contribute to economic growth justify the increasing efforts being made to promote them, both in the region and in other parts of the world.

2. The transition period of liberalization

Generally speaking, trade reforms have taken place in the context of sweeping changes in which international competitiveness and exports play a key role. The main instrument of reform in Latin America has been the more or less indiscriminate and rapid liberalization of imports. The purpose of opening up the economy has been to expose domestic producers of importable items, who have frequently enjoyed in the past considerable protection to external competition. Liberalization would enhance productivity and reduce inefficiency by allowing the economy to absorb new technologies and increase specialization. In extreme situations, those producers who did not adapt to external competition would be driven out of the market. The resources thus released would be absorbed mainly by the production of exportables.

Indirect export incentives include the lower cost and greater variety of importable inputs to which producers have access, and the eventual depreciation of the national currency which import liberalization would tend to generate in the exchange market.

All of these are effects that tend to occur to some extent. What matters is how fast they occur, and how the positive and negative effects are distributed in the course of the economy's adjustment to the reforms. The outcome is not a single trajectory or goal, since much depends on the point of departure, the other economic policies adopted during the process, and the external context.

The response of producers of import substitutes depends on the magnitude of changes in relative prices, the rapidity of the changes, and the capacity of the producers to adjust. The ideal situation is one in which producers are given enough time to restructure, but only the time strictly necessary, so that they are effectively pressured to increase their productivity. For example, "water" or redundant nominal protection should be removed immediately. However, except for reasons of political feasibility, it is preferable that effective protection should be reduced at a rate in line with the time producers need to introduce innovations, increase specialization and reallocate resources.

The response of exports depends on how much they use importable items and the trade policy applied to these items before the reform. Inputs and capital goods imported by exporters have normally enjoyed certain tariff exemptions, but there are also numerous cases where exports were discouraged by an inoperative or arbitrary import regime. More specifically, the development of non-traditional exports was constrained by a lack of access to crucial inputs, since import exemptions were normally available to exporters only in already established activities.

For reform to be successful the net effect of changes in incentives must be to boost the production of tradable goods. One determinant of how production of both exportables and importables will respond is the evolution of the real exchange rate.

The combination of changes in relative prices, their credibility and gradualness, and the macro- and meso-economic context in which reform takes place determines whether the stimuli given to resource allocation are primarily positive or negative, in other words, whether being exposed to competition during the adjustment process is creative or destructive. This in turn determines whether restructuring expands the frontier of production, as it did in the Asian NIEs, or whether its initial effect is a drop in economic activity or a slower recovery of a recessive market, in an adjustment process that moves below the production frontier.

In the last-mentioned case, the stimuli arising from a drop in import substitution are stronger in the beginning than the positive effects of an expansion of exports. The enterprise that survives under the second strategy may be stronger and more dynamic on average than in the first case. However, in the short term there is more destruction than creation: more businesses fail than are set up. Consequently, during the first years of adjustment there will be fewer productive resources available and in full use, since businesses are either failing or cutting back: this could mean further underutilization of resources, and the stimulus for total investment would tend to be weaker. Therefore, greater "microeconomic efficiency" would tend to coexist with less "macroeconomic efficiency". The hysteresis of the process determines the final outcome. Indeed, what happens during the transition decisively affects the well-being and the production structure attained by the end of the adjustment process. Countries such as Japan, the Republic of Korea and the Taiwan Province of China solved this problem by first promoting exports (which tend to expand capacity) and only later, gradually and in a context of high capital formation, opening up to imports (which during rapid liberalization tend to destroy capacity).

The speed of the adjustment will depend on the credibility of the timing of the

change, particularly the initial situation, the initial level and the evolution of the exchange rate, and on producers' access to the resources needed to restructure: available skilled manpower, technology, accessible long-term financing at reasonable interest rates, suitable infrastructure, receptive external markets and a domestic market in a context of macroeconomic equilibrium.

For example, in a highly distorted environment, with imports severely and arbitrarily suppressed by quantitative mechanisms, replacing these mechanisms with tariffs could considerably improve efficiency. Import regime reform could make it easier to expand both exports and import substitution, which had been constrained by an inadequate supply of intermediate goods and services and capital.

3. The impact of exchange rate policy on the growth of exportable supply

One of the main instruments affecting the growth of exportable supply is exchange rate policy. A devaluation increases the net return in local currency to exporters and therefore stimulates export activity. However, it is known that sporadic devaluations alone do not encourage exports. The export sector needs constant incentives in order to develop, since investment resources must be reallocated from one sector to another.

Large inflows of external capital, a phenomenon of the late 1970s and recent years, have led many countries to revalue their currency, which may have helped to stabilize the inflation rate but in some cases discouraged the allocation of resources to export production. However, recent reforms in trade policy have in many cases helped to offset the effect of revaluation on the export sector, by lowering tariffs on imported inputs needed to produce exportable goods, or by granting direct subsidies to such goods.

Table IV.1 presents, for some countries, trends in the volume of industrial or non-traditional exports (which have shown the highest growth during the decade) and in the exchange rate and trade policy indicators. The table shows steady growth in export volume during the period 1985-1989 in Colombia, Chile and Mexico, and fluctuating trends in Argentina and Brazil. In the second half of that period, the real exchange rate and subsidies to the sector declined. Revaluation is clearly seen in Argentina from 1989 onwards, in Brazil between 1987 and 1990, in Mexico from 1988 onwards and in Chile from 1990. However, in all these countries, revaluation took place after a considerable number of devaluations in the preceding years, associated with the external debt crisis, which not only had a short-term impact but also affected long-term trends in exports. In Brazil's case, the real exchange rate had been depreciating since the mid-1970s; exchange rate policy therefore benefited the export sector over a long period of time.

In order to evaluate the impact of changes in the exchange rate and related instruments on export trends in the short and long term, the magnitude of response and speed of adjustment to variations in these policies must be measured. Econometric studies, which have been available for several decades in several countries of the region, can provide that information.

A review of these studies reveals certain limitations: i) they use different methodologies to measure the real exchange rate relevant to the export sector, i.e., the one that affects its profitability;[32] ii) there is no homogeneous profit ratio to measure

32 The normal procedure is simply to consider the nominal exchange rate against the dollar, deflated by a domestic price index or by an index of average exchange rates against the currencies of the target countries. This latter index can also be inflated by an index of external prices or by the unit value of exports in order to obtain a measure of relative prices between the external and domestic markets. Some studies have adopted a real effective exchange rate, adjusting it by an index of subsidies and other export incentives.

Table IV.1
EXPORT VOLUME, REAL EXCHANGE RATE AND TRADE POLICY [a]
(Indexes 1985 = 100)

	1980	1982	1984	1985	1986	1987	1988	1989	1990	1991
Argentina										
Industrial exports	74.8	83.6	67.8	100.0	82.1	82.3	111.5	139.2	184.4	157.2
Real exchange rate	60.6	107.9	94.6	100.0	107.4	131.3	136.5	144.2	113.4	85.8
Drawbacks	116.0	116.0	107.0	100.0	104.0	110.0	106.0	103.0	105.0	111.0
Brazil										
Industrial exports	40.9	55.3	102.7	100.0	87.3	91.6	114.1	111.9	101.0	107.2
Real exchange rate	89.5	69.4	97.2	100.0	106.4	103.6	94.4	72.2	64.8	75.8
Subsidies	91.6	155.7	107.6	100.0	109.3	111.9	108.9	98.0	88.2	92.6
Colombia										
Non-traditional exports	99.3	117.6	94.9	100.0	126.0	142.0	176.7	214.2	265.6	336.7
Real exchange rate	89.6	77.2	86.1	100.0	131.6	147.3	149.5	152.6	172.7	171.1
Subsidies	57.2	71.2	102.3	100.0	69.7	59.1	53.4	56.1	48.1	40.2
Tariff index	73.3	76.6	106.1	100.0	94.0	97.7	95.6	93.5	68.0	64.4
Chile										
Non-copper exports	66.7	87.8	90.7	100.0	113.3	112.2	125.5	144.4	142.6	146.0
Real exchange rate	71.2	65.9	79.7	100.0	123.2	134.0	140.9	133.4	139.7	137.9
Tariff index	39.1	39.1	94.6	100.0	77.9	77.5	58.5	58.5	58.5	50.7
Mexico										
Industrial exports	51.1	49.6	104.1	100.0	123.9	146.7	174.0	179.9	193.6	209.3
Real exchange rate	81.7	107.7	100.1	100.0	138.8	144.9	118.2	110.3	107.5	98.1

Source: ECLAC, on the basis of official figures.
[a] Export indexes correspond to volume indexes. The real exchange rate, calculated by ECLAC, corresponds to the nominal exchange rate inflated by the external price index of the main trading partners and deflated by the consumer price index. Tariff and subsidies indexes are calculated on the basis of nominal averages.

the impact of liberalization, tariff reduction or promotional mechanisms; iii) they use different econometric models and methods;[33] consequently, results are not strictly comparable and could be considered weak. However, a review of these models gives some idea of the effect of these variables on export growth.

Table IV.2 gives the results of recent studies (from the 1980s) on short- and long-term price elasticities of aggregate exports (elasticities in relation to the real exchange rate measured by one of the methods described in footnote 32), obtained on the basis of estimates of the supply function for non-traditional exports for some countries.[34]

Table IV.2 shows the difference between the short- and long-term effects of exchange rate policy.[35] Elasticity with respect to an exchange rate variation in the short term is well below one in all the countries, which indicates a certain inelasticity of supply, or little reaction to short-

33 Generally speaking, the model normally used in Latin America, under the small-country assumption, is that of partial adjustment for a supply equation, and the method of estimation used is ordinary least squares. This assumption does not apply to Brazil, where supply and demand equations are estimated through least squares in two and three stages. Also, recent models for correcting estimated errors use the method of maximum likelihood with complete data.

34 For a definition of export supply functions see Moguillansky and Titelman (1993).

35 A short-term response is one which takes place within the same period (quarter or year) as the policy variation.

Table IV.2
AGGREGATE EXPORT SUPPLY ELASTICITIES IN SOME LATIN AMERICAN COUNTRIES

Country	Short-term elasticity	Long-term elasticity	Period estimated
Argentina	0.39 (1 lag)	n.s	1970-1992[a]
Brazil	0.38	0.91	1970-1986[b]
Bolivia	0.39	0.81	1980-1990[a]
Colombia[c]	0.51	0.93	1967-1991[a]
Costa Rica[d]	0.03	0.15	1970-1989[b]
Chile[e]	0.32	1.26	1963-1990[a]
Ecuador[f]	n.s	n.s	1970-1987[a]
Mexico[f]	0.12	n.e	1982-1987[b]

Source: For Argentina: F. Navajas, "Una estimación de la función agregada de exportaciones. Argentina: 1970-1992", Buenos Aires, Argentina, ECLAC office in Buenos Aires, August 1993, unpublished; for Brazil: A. Zini, "Funções de exportação e de importação para o Brasil", *Pesquisa e planejamento económico*, vol. 18, No. 3, December 1988; for Bolivia: R. Ferrufino, "El tipo de cambio real y la balanza comercial en Bolivia durante el período de post-estabilización", *Análisis Económico*, vol. 6, La Paz, Economic Policy Analysis Unit (UDAPE), 1993; for Colombia: L. Villar Gómez, "Política cambiaria y estrategia exportadora", document presented at the Thirteenth Simposium on the Capital Market, Santa Fe de Bogotá, Asociación Bancaria de Colombia, October 1992, unpublished; for Costa Rica: A. Hoffmaister, "The cost of export subsidies, evidence from Costa Rica", *IMF Staff Papers*, vol. 39, No. 1, 1992; for Chile: G. Moguillansky and D. Titelman, "Análisis empírico del comportamiento de las exportaciones no cobre en Chile: 1963-1990", *Working Paper* series, No. 17, Santiago, Chile, ECLAC, 1993; for Ecuador: ILPES/CONADE (Latin American and Caribbean Institute for Economic and Social Planning/National Development Council) (1989), "Modelo macroeconómico de Ecuador", Quito, CONADE, July 1989; for Mexico: R. Peñaloza Webb, "Elasticidad de la demanda de las exportaciones: la experiencia mexicana", *Comercio exterior*, vol. 38, No. 5, May 1989.

Note: 1. A dash (-) indicates zero or insignificant quantity.
2. n.e. = not estimated.

[a] Annual. [b] Quarterly. [c] Includes all exports except coffee, petroleum, ferronickel and gold. [d] Non-traditional exports. [e] Total non-copper exports. [f] Non-petroleum exports.

term devaluations or revaluations. However, the reaction is much stronger in the long term, in which elasticity is close to or slightly above one, indicating that in the period in which economic agents take their investment decisions, profitability is an important variable, so that a variation of 1% in the real exchange rate generates a 1% or slightly higher increase in export supply. If the observed export elasticities are compounded by an impact on imports, the effect of exchange rate policy on the trade balance is even greater.

Table IV.2 also shows that in some countries, for example Ecuador and Costa Rica, the impact of changes in the real exchange rate in both the long and the short term is very slight or insignificant, which might be related to the nature of their exports: bananas, coffee, cocoa and shrimp in Ecuador; shrimp, plants, flowers, foliage and pineapples in Costa Rica, which are produced almost exclusively for the export market. It is possible that in the beginning and early stages of these activities the profit margins ensured by external prices and low wage costs were high enough not to have been seriously affected by changes in the real exchange rate.

The behaviour of exports in relation to exchange rate policy in the region contrasts with that of some economies in South-East Asia, such as the Republic of Korea and Hong Kong, where the growth of exportable supply between the late 1960s and the mid-1980s coincided with a competitive, stable real exchange rate in comparison with Latin American rates (Balassa and Williamson, 1987). Studies of those economies show that short-term elasticity of aggregate export supply was

very high: Balassa's estimates (1991) for the Republic of Korea fluctuate between 1.9 and 2.2 for the period 1965-1987, while Riedel (1986) estimates a real exchange rate elasticity for Hong Kong of 5.0 for the period 1972-1984.

The first conclusion that can be drawn from the above is that exchange rate policy has a significant long-term impact, although, given the magnitude of the reaction (elasticity is equal to or slightly above one), other instruments are needed to promote rapid growth. Likewise, the relatively low elasticities of exports in relation to the exchange rate reveal the problems faced by exporters, in terms of financing, technology, human resources and infrastructure, in their efforts to take advantage of these better relative prices. Thus, the purpose of a systemic effort to enhance competitiveness is precisely to gradually raise these elasticities.

Sectoral studies show how important it is to differentiate the effects of changes in profitability by kinds of activity.

Indeed, a comparison of tables IV.2 and IV.3 shows that short- and long-term elasticity in the manufacturing sector is, in every country studied, higher than that of aggregate exports. Adjustment velocity also differs from product to product, with manufacturing being the fastest. An analysis of the results at the level of industrial subsectors shows that the response to exchange rate policy in some of them is very high (elasticity much higher than one), even in the short term, indicating that these export activities can be very negatively affected by a rise in the real exchange rate. This is the case, for example, in the food, textile and chemical industries in Colombia, and the textile, metal products, electrical machinery and automotive industries in Mexico.[36]

In the case of Chile, fresh fruit and agricultural exports are slow to react to short-term changes in the exchange rate; in that sector, the effects of such changes and the velocity of adjustment are considerably less significant than in the manufacturing sector. This is to be expected, given the nature of investment in fruit growing and the number of years before output is ready to harvest. This means that if an attempt is made to use exchange rate policy to stimulate this sector in a temporary crisis situation, there will be no visible results in the short term. In the manufacturing sector, however, the exchange rate stimulus elicits a greater response.

The results of the study of Brazilian industry show that while changes in the exchange rate have a delayed impact on manufactured products, their impact on semi-manufactures is instantaneous. Long-term elasticity also differs; it is greater than one for manufactures, whereas exports of semi-manufactures show no long-term correlation to the real exchange rate. This is because of the characteristics of these industrial commodities and the timing of the maturation of large investments made in the mid-1970s. In this case, foreign sales had more to do with the need to cover investment costs in a context of domestic recession than with relative prices between the domestic and foreign markets.

This analysis shows that the sensitivity of exports to real exchange rate fluctuations varies according to the sector or kind of product and that the repercussions are mixed. Moreover, estimates show that elasticity increases in direct proportion to added value. It can also be seen that exports from countries whose industrial development and diversification are more advanced permit stronger more immediate responses to changes in exchange rate policy.

Lastly, since the real exchange rate for exports is measured as corrected by their

36 Cohen's study (1989) of industrial subsectors in Mexico, disaggregated to four digits, also shows that price elasticities are positive and significant for 23 of the 28 sectors studied. This is consistent with the results obtained for the aggregate manufacturing sector by Mendoza (1993), but contrasts with the lack of sensitivity of Mexico's aggregate non-petroleum exports, as estimated by Peñaloza Webb (1988).

Table IV.3

ELASTICITIES AND ADJUSTMENT VELOCITY IN RELATION TO REAL EXCHANGE RATES IN SECTORAL EXPORT FUNCTIONS

Country and product	Short-term elasticity	Long-term elasticity	Average lag	Period
Brazil				
Industrial products	0.58	1.39	1.72 [a]	1970-1986 [a]
Manufactures	0.47	1.16	2.10 [a]	1980-1991 [a]
	(1 lag)		-	
Semi-manufactures	0.81	-	-	1980-1991 [a]
Colombia				
Agricultural products	0.86	3.7	2.00 [b]	1970-1992 [b]
Manufactures	0.80	1.1	2.00 [b]	1970-1992 [b]
- Foodstuffs	1.17	n.e.	n.e.	
- Textiles	2.20	n.e.	n.e.	
- Chemicals	2.40	n.e.	n.e.	
Chile				
Fresh fruit	0.18	1.80	10 [b]	1963-1990 [b]
	(1 lag)			
Other agricultural products	0.33	0.58	1.78 [b]	
	(3 lags)			
Manufactures	0.65	1.93	0.52 [b]	
Mexico				
Manufactures [c]				
Textiles	1.64	n.e.	n.e.	1982-1988 [a]
Petrochemicals	0.48	n.e.	n.e.	
Metal products	1.53	n.e.	n.e.	
Electrical machinery	1.54	n.e.	n.e	
Automobiles	2.54	n.e.	n.e.	
Peru				
Manufactures	3.68	n.e.	n.e.	1963-1983 [b]

Source: For Brazil: G. Moguillansky, "Determinantes de las exportaciones industriales brasileras en la década de 1980", Santiago, Chile, ECLAC, July 1993, unpublished; A. Zini, "Funções de exportação e de importação para o Brasil", *Pesquisa e planejamento económico*, vol. 18, No. 3, December 1988; for Colombia: G. Alonso, "Determinantes de la oferta de exportaciones menores colombianas", Santa Fe de Bogotá, Banco de la República, May 1993, unpublished; for Chile: G. Moguillansky y D. Titelman, "Análisis empírico del comportamiento de las exportaciones no cobre en Chile: 1963-1990", *Working Paper* series, No. 17, Santiago, Chile, ECLAC, May 1993; for Mexico: A. Cohen, "Trade policy in Mexico: an analysis of structural change", Berkeley, University of California, Ph.D. dissertation, 1989, unpublished; for Peru: C. Paredes, "Exchange rates regimes, the real exchange rate and export performance in Latin America", *Brookings Discussion Papers in International Economics*, No. 77, Washington, D.C., The Brookings Institution, August 1989.

Note: 1. A dash (-) indicates zero or insignificant quantity.
2. n.e. = not estimated

[a] Quarterly. [b] Annual. [c] Certain industrial subsectors were chosen to illustrate the variation range of intersectoral elasticities.

unit value (which implicitly includes a weighted average of external prices), a basket of currencies of the country's main trading partners is taken as a benchmark. This is important, since the countries of the region have frequently been guided only by variations in the United States dollar in designing their exchange rate policies.

Table IV.4 shows the contribution of real exchange rate variations to export growth in Brazil, Chile and Colombia during the period 1980-1991, taking into account estimated long-term elasticities. In Brazil's case, manufactures exports could have grown by a further 18% if the real exchange rate had not been revalued by 15% between 1980 and 1991. As some studies show (Bonelli, 1992; Baumann, 1993b and Moguillansky, 1993), especially during the second half of the 1980s, manufacturers in Brazil turned to the export market because of the recession in the domestic market, external demand (in some cases ensured by the links between transnational export firms and their parent company or subsidiaries located in other countries) and enhanced competitiveness, rather than because of the profits to be made during that period.

In Chile, on the other hand, the 35% depreciation in the real exchange rate for non-copper exports explains their 37% growth over the past 11 years, and the same is true in Colombia: more than a third of the enormous growth in non-traditional exports is attributable to a 91% depreciation in the real exchange rate during the period.

4. Exchange rate policy, competitiveness and trade policy

Greater competitiveness reduces the costs of exports in relation to the corresponding international costs. This relationship depends on wages, tariffs and other domestic costs as compared with external costs, the exchange rate and especially the productivity of local industry, which in turn depends on innovations, organizational improvements and technological development.[37] Under the systemic approach to international competitiveness outlined by ECLAC —which entails simultaneous, integrated advances in a number of variables— it is nonetheless worth investigating whether any of these variables has had more impact than others on the competitiveness of the export sector.

This question has been researched at least in Brazil and Mexico. For Brazil, Bonelli (1992) indicates that the competitiveness of industrial exports rose significantly in the first half of the 1980s, owing both to productivity gains and to exchange rate and wage fluctuations. During the second half of the decade, however, a deteriorating exchange rate/wage ratio clearly contributed to the fact that the competitiveness of manufactures exports increased far less —although it still increased— than in the previous period.

Casar's study of Mexican industry (1993) shows that in most of the subsectors that increased their competitiveness in the period 1980-1989, the determining factor was a rise in labour productivity. In the more backward subsectors, on the other hand, competitiveness was associated with low wages and the real exchange rate.

Few estimates have been made in Latin America of the impact of competitiveness (i.e., the ratio between the relative cost at which a product is sold abroad and its international market price) on export development. Econometric estimates of demand functions for industrial exports in Brazil (historically the most developed in the region) show strong short-term elasticity, much higher than the impact of profitability on exportable supply of both manufactured and semi-manufactured products. In order to maintain competi-

37 ECLAC emphasized these points in its proposal on changing production patterns with social equity (ECLAC, 1990a and 1992a), according to which competitiveness is sustainable in the long term if it is genuine, i.e., if it is not overly dependant on the favourable evolution of the exchange rate/wage ratio.

Table IV.4

CONTRIBUTION OF REAL EXCHANGE RATE VARIATIONS TO EXPORT GROWTH, 1980-1991

Cumulative effect during the period	Export growth (volume)	Real exchange rate variation (total variation during the period)	Long-term elasticity	Impact of real exchange rate on exports	Contribution of real exchange rate to export growth
	(A) %	(B) %	(C)	(B)·(C) %	(B)(C)/(A) %
Brazil Manufactures exports	155	-15	1.16	-18	-12
Chile Non-copper exports	119	35	1.26	44	37
Colombia Non-traditional exports	239	91	0.93	85	36

Source: For Brazil: G. Moguillansky, "Determinantes de las exportaciones industriales brasileras en la década de 1980", Santiago, Chile, ECLAC, July 1993, unpublished; for Chile: G. Moguillansky and D. Titelman, "Análisis empírico del comportamiento de las exportaciones no cobre en Chile: 1963-1990", *Working Paper* series, No. 17, Santiago, Chile, ECLAC, 1993; for Colombia: L. Villar Gómez, "Política cambiaria y estrategia exportadora", document presented at the Thirteenth Symposium on the Capital Market, Santa Fe de Bogotá, Asociación Bancaria de Colombia, October 1992, unpublished.

tiveness when an exchange rate revaluation is unavoidable and fiscal or financial incentives are lacking, the alternatives are to increase productivity or accept lower profit margins. This is what apparently took place in Brazil in the second half of the 1980s, when the fiscal crisis made it impossible to continue to finance the same level of incentives as before.

Trade reforms have greatly reduced costs, especially when the export sector previously had no tax exemptions on imported inputs. Trade liberalization also made it possible to import a greater variety and higher quality of inputs, which in turn often led to higher profitability and helped stimulate export supply. In other instances, liberalization or tariff exemptions partially offset the decline in profitability brought about by an appreciation of the real exchange rate as a result of stabilization policies or inflows of external financing.

With respect to this last point, figures IV.1 to IV.4 show the evolution of the real exchange rate and an index of tariffs on imported inputs and incentives for four countries.[38] Figure IV.1, for Argentina, shows that while export drawbacks on manufactures remained steady, the real exchange rate appreciated sharply from 1989 onwards, without there being any compensation between the two policies.

In Brazil, export benefits and subsidies moved in the same direction as exchange rate policy from 1985 onwards, so that during the revaluation period the export sector received no compensatory incentives. However, producers have benefited from the trade reform implemented gradually from 1987 onwards, which shortened the list of prohibited imports, simplified red tape and lowered tariffs: the

38 As in measurements of the real exchange rate, indexes of tariffs and incentives are not homogeneous among countries. In the case of tariffs, they are nominal averages. In the case of incentives, they include subsidies, drawbacks, tax exemptions, etc. Export incentives in Brazil and Colombia represent the potential total share, i.e., what would happen if all exporters benefited from all the incentives.

Figure IV.1

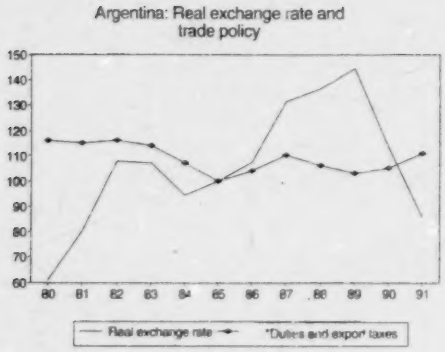


Figure IV.2

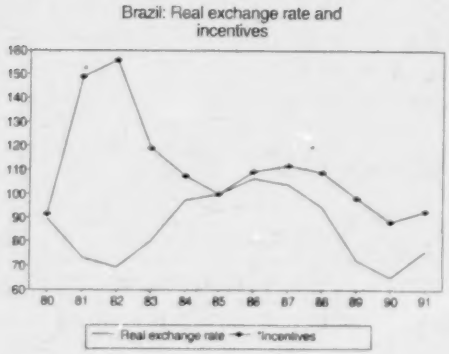


Figure IV.3

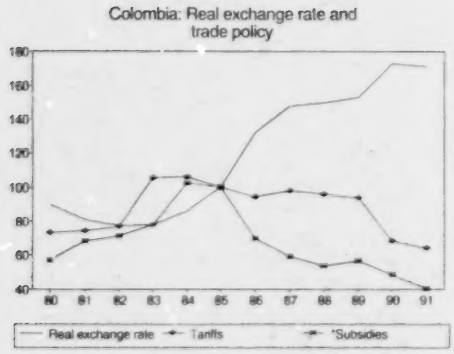
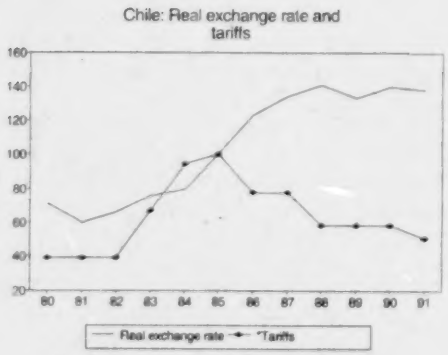


Figure IV.4



Source: ECLAC, on the basis of official figures.

average duty on imports was reduced from 51% in 1987 to 14% by the end of 1993.

Figure IV.3, on Colombia, shows a sharp drop in subsidies for non-traditional exports, but this was offset by a depreciation in the real exchange rate and by the gradual reduction of tariffs. A similar evolution in exchange rate policy took place in Chile from 1985 onwards, accompanied by a gradual reduction of the average tariff level, which had risen in 1982 in response to the external debt crisis.

5. Exchange rate uncertainty and export growth

Uncertainty about exchange rate policies and their instability has an impact on production for the export market. If entrepreneurs are unsure about the future real exchange rate or its possible range of variation (which in turn determines expectations of profitability), they are hardly likely to invest in the export sector. Exchange rate instability is also often associated with trade policies that are ephemeral and have little credibility, and this neutralizes the intended incentives to economic agents.

Since exchange rate policy does not exist in a vacuum from other economic policies, such as monetary and fiscal policies, it is bound to be subject to some instability. For example, a devaluation in a highly unbalanced fiscal situation, which forces an unprogrammed increase in the money supply, quickly triggers an inflationary situation that neutralizes the authorities' attempt to devaluate or maintain the real exchange rate; this uncertainty about exchange rate trends affects export performance.

One way of empirically measuring the impact of exchange rate volatility is by an indicator of real exchange rate variability.[39] Table IV.5 gives the results obtained for some countries.

We can see that the elasticities observed in different studies are high and negative in the short term. This is because an increase in instability raises costs without allowing them to be transferred to export prices, and this acts as a disincentive to selling in foreign markets.

As mentioned above, long-term instability influences investment and reduces exportable supply. The strong estimated impact in Peru (-4.7) is consistent with the degree of instability measured by the coefficient of real exchange rate variation during the period 1960-1985.[40] In Colombia and Chile, on the other hand, with a more stable exchange rate, this variable has no statistically significant impact on exports. In the case of Chile, the lower short-term elasticity found in Paredes' study (1989) for the period 1963-1983 coincides with greater exchange rate stability throughout the 1960s, while the study by Caballero and Corbo (1989) concentrates more on years of high instability (1970-1985).

These results, together with those mentioned in the previous section, confirm the need to ensure stable exchange rate policies in order to maintain long-term growth in the export sector.

6. Other factors influencing exports

Along with exchange rate policy, tariff reforms and direct benefits that affect the profitability of the export sector, other factors have intervened in the growth of merchandise sales in foreign markets. These include pressures from domestic demand on available supply, the role of regional integration processes and trends in external demand.

39 Empirical studies carried out since the mid-1970s show a significant negative relationship between real exchange rate volatility and exports: see Díaz-Alejandro (1976) for Colombia and Coes (1979) for Brazil. The most important studies of the 1980s are those by Paredes (1987), Caballero and Corbo (1989) and Alonso (1993).

40 See Paredes (1989) and Alonso (1993). The coefficient of variation was taken to be the average annual standard deviation divided by the mean, calculated on the basis of monthly data.

Table IV.5
ELASTICITY OF EXPORTS IN RELATION TO REAL EXCHANGE RATE VOLATILITY

	Short-term elasticity	Long-term elasticity	Period
Chile	- 1.9	-	1963-1983
Peru[a]	- 4.3	-	
Colombia	n.s.	-	1970-1985
Chile	- 5.4	-	
Peru	- 1.1	-4.7	
Colombia			1970-1992
Agriculture	- 0.3	- 0.6	
Industry	- 0.2	- 0.2	

Source: For Colombia: G. Alonso, "Determinantes de la oferta de exportaciones menores colombianas", Santa Fe de Bogotá, Banco de la República, May 1993, unpublished; for Chile: R.J. Caballero y V. Corbo, "The effect of real exchange rate uncertainty on exports: empirical evidence", *The World Bank Economic Review*, vol. 3, No. 3, May 1989; for Peru: C. Paredes, "Exchange rates regimes, the real exchange rate and export performance in Latin America", *Brookings Discussion Papers in International Economics*, No. 77, Washington, D.C., The Brookings Institution, August 1989.

Note: A dash (-) indicates zero or insignificant quantity.

[a] Paredes, in fact, founds high elasticities (-1.5 for the short term and -3.6 for the long term) also for Brazil, but his results are distorted by the period of analysis. Compare, for example, with the data compiled by Nogués (1990) who, in analysing eight Latin American countries in the period 1978-1987, observed that Brazil was the country whose real exchange rate had varied the least. Like the present study, Nogués believes that stabilizing the real exchange rate is more important than providing export incentives.

The purpose of some econometric studies is to find out to what extent pressure from domestic demand determines export-oriented production. The indicator of short-term pressure from domestic demand that is used is the rate of utilization of productive capacity, which measures the gap between actual and potential output.

Of the studies that exist, only those on Brazil confirm the impact of fluctuations in domestic demand on exportable supply.

Historically, there has been a significant negative correlation in Brazil between the rate of utilization of productive capacity and industrial exports, with very high elasticities.[41] This implies that entrepreneurs have turned to export markets more as a defence mechanism against domestic recession than as a conscious effort to develop their export activity. This is confirmed by the results of surveys of the industrial export sector (Baumann, 1993b).

Moreover, the estimated long-term elasticities of capacity utilization were higher than those obtained for potential output, suggesting that manufactures exports will be limited, in a context of economic growth, by the need to meet domestic demand, unless investments are made which increase productive capacity.

The magnitude of the impact of external demand on exports differs according to the type of product. Traditionally, the income elasticity of commodity exports has been low when measured against the level of activity of the industrialized countries, while the income elasticity of industrial products depends on the kind of goods exported.

41 See the summary of results drawn up by Zini (1988) and those obtained by Moguillansky (1993).

The "small country assumption" has been used in estimating export functions for manufactures. This means that exporters can sell to the external market as much as they are able to produce. Consequently, export prices are not affected by the quantity exported, since they are determined by the international market.

However, this assumption has been found to be invalid for some countries. In the case of Brazil's manufactures exports, for example, the best adjustments were obtained on the basis of an estimate of simultaneous models of export supply and demand. The demand equations show high, significant coefficients for income elasticity,[42] indicating that industrial exports are affected by trends in the external market.

In Villar's (1992) estimates for Colombia, elasticity with respect to an index of real GDP of the countries to which Colombia exports is high in the short term. He also suggests that the underestimation of non-traditional exports generated by the econometric model for 1991 can be partially explained by the rapid process of trade integration between Colombia and Venezuela, which caused exports to Venezuela to increase by 152% that year and helped maintain that rise in 1992. Similar effects occurred in trade between Argentina and Brazil, Bolivia and Ecuador, and Chile and Peru.

This requires looking at another factor that has influenced recent export performance, namely, regional integration processes.

Data for different countries of the region show that positive performance in intraregional exports and exports to third countries are in fact complementary. There is a significant positive, correlation between the coefficient of intraregional industrial exports and the proportion of domestic demand met by imports from other regions. This shows that the ready availability of quality inputs at competitive costs is a decisive factor for productivity in producing non-traditional exports. Moreover, empirical evidence shows that exporting to markets in the same region can offer learning opportunities for entering extraregional markets.[43]

7. Conclusions

The above points can be summarized in the following general conclusions. First, a look at the impact of changes in the real exchange rate on aggregate exports, except for certain countries, shows a long-term elasticity close to or somewhat above one. Thus, exchange policy can be seen to have a significant effect. Nevertheless, there is an implicit need to also use other stimuli to ensure rapid development of the export sector. Gradual elimination of anti-export biases and deficiencies in infrastructure, technology, financing, human resources and external promotion should gradually increase the response of exports to the exchange rate. This is evident even in the short-term elasticity of exports in relation to the exchange rate in the Asian economies.

Second, both the real exchange rate and other stimuli should be stable. Uncertainty about exchange rate policy discourages investment in the export sector, while unstable incentives appear unreliable and economic agents ignore them.

Third, a disaggregation of the export sector by type of product shows that the effects of exchange rate policy are mixed, and that also the greater the diversification and installed capacity in industry, the more sensitive the response to exchange rate policy: exports from more industrially diversified and developed countries respond more strongly and more immediately to exchange rate policy.

The elasticity of the manufacturing sector is in all cases higher than that of aggregate exports, in both the short and

42 The GDP of the target countries or an index of those countries' imports was used as an indicator of external demand.

43 For more on this point, see chapter III and ECLAC (1994a).

the long term, and this sector also responds more quickly, especially in countries which historically have achieved greater industrial diversification and have developed greater productive capacity. Exchange rate policy elicits little short-term response from agricultural activities; any attempt to stimulate this sector in a temporary crisis will therefore be ineffective if exchange rate policy is the only instrument used.

An evaluation of policy at the level of industrial subsectors shows high elasticities in both the short and the long term in certain cases, indicating that some export activities can be seriously hurt by a revaluation of the real exchange rate.

Fourth, in the countries studied, tariff reforms have been beneficial for export development, but once they are implemented, they cease to be determining factors in further export development.

Fifth, domestic demand has an important impact on branches of industry not specifically geared to the export market. To maintain exportable supply in these cases, new investment resources must be allocated, or investment incentives provided, for these activities.

Lastly, trends in external demand are crucial to the performance of commodities, but are also significant for some countries' industrial exports.

Chapter V

TRADE POLICY

1. Recent trade liberalization processes

The mid-1980s saw the emergence of a clear trend that represents a radical turnaround in development strategy and in the policies associated with it, after over half a century of protectionism. As shown in table V.1, reforms aimed at liberalizing trade have been widespread in the region in recent years. Of the nine countries listed in the table, the vast majority implemented reforms that could be termed drastic and swift, as imports were liberalized in as little as two to three years.

The reforms undertaken are not easy to pigeonhole, but two broad categories can be distinguished. The first comprises the attempts observed in some countries —such as Chile since 1974, Argentina in 1976-1981 and again in 1988, and Bolivia since the mid-1980s— to liberalize both trade and capital movements at the same time, as part of a larger process of economic liberalization. The second category consists of experiences —particularly in Brazil, Colombia and, initially, Mexico— where high levels of protection of various types were kept in place for several decades, while their adverse effects on productive activities were largely offset by strong export incentives.

These trends in the region's trade policies have been complemented by a concomitant wave of bilateral trade liberalization agreements, some of which entail the adoption of common tariff structures (ECLAC, 1994a). In some countries, such as those of Central America (Costa Rica and Guatemala, for example), the combination of subregional integration agreements and structural adjustment programmes strongly influenced national tariff-reduction processes, especially after the mid-1980s.

To a great extent, all of these reforms included the elimination of most quantitative restrictions and provided for substantial tariff cuts. In general, they represented an appreciable change with respect to the tariff protection in force prior to the reforms (see table V.1) and dramatically reduced the degree of dispersion of effective protection. However, no country has adopted a zero tariff, and only in Chile has a uniform tariff, currently 11%, been established.

a) Experiences in wide-ranging liberalization

Until recently, one of the common features of the countries of the region was the practice of imposing sizeable, highly dispersed tariffs to which surcharges and specific duties applied at given times were often added, along with various types of non-tariff barriers. For manufactures, the resulting levels of effective protection generally were notably higher than nominal levels.

Often, however, the impact of these measures was partly offset by equally

Table V.1

LATIN AMERICA (SELECTED COUNTRIES): SUMMARY OF THE TRADE LIBERALIZATION PROCESS

Country	Programme starting date	Maximum tariff		Number of tariff rates		Average tariff		Non-tariff barriers	Variation in real exchange rate[a]
		Initially	Year-end 1993	Initially	Year-end 1993	Initially	Year-end 1993		
Argentina[b]	1989	65	30		3	39[c]	15[c]	In 1988 the value of industrial production subject to restriction was reduced from 62% to 18%. In 1989-1991 non-tariff restriction, temporary additional duties and specific duties were eliminated.	-49
Bolivia	1986	150	10		2	12[d]	7[d]	With few exceptions, all import bans and licence requirements were abolished.	92
Brazil	1988	105	35	29	7	51[e]	14[e]	In 1990 the list of banned imports and prior-licencing requirements were eliminated. However, national-content requirements for intermediate and capital goods will be maintained.	44
Colombia[b]	1990	100	20	14	4	44[d]	12[d]	Nearly all restriction concerning the prior-licencing requirement were lifted in late 1990.	-4
Costa Rica	1986	100	20		4	27[e]	14[e]	Import permits and other restrictions were phased out in 1990-1993.	10
Chile[f]	1973	220	10	57	1	94[e]	10[e]	In the 1970s, quantitative limits on imports were eliminated.	-10
	1985	35	11	1	1	35[e]	11[e]	Price bands were re-introduced and an antidumping system was established.	32
Mexico	1985	100	20	10	3	24[c]	12[c]	The coverage of import permits was reduced from 92% of foreign purchases in June 1985 to 18% in December 1990, and official import prices were eliminated.	-15
Peru[b]	1990	108	25	56	2	66[e]	18[e]	Import licences, controls and authorizations, as well as quotas and bans, were eliminated in September 1990.	-28
Venezuela	1989	135	20	41	4	35[d]	10[d]	The number of categories subject to restrictions was reduced from 2,200 in 1988 to 200 at the present time. Specific duties, which in some cases had raised the maximum tariff to 940% prior to the liberalization programme, were abolished.	15

Source: ECLAC, on the basis of national figures.

[a] From the year before the liberalization programme began up to 1993, the exchange rate for exports has been used.
[b] Tariffs include surcharges. [c] Weighted by domestic production. [d] Weighted by imports. [e] Simple average of tariff items. [f] Chile's first trade liberalization programme was completed in 1979. The uniform tariff of 10% remained in force until 1982. Thus, the information in the first row is for that period (1973-1982). The second row contains information on the reduction of import tariffs, which, after rising to 35% in 1984, were successively reduced to 20% (1985), 15% (1988) and 11% (1991).

wide-ranging systems of various kinds of exceptions (especially under regional and sectoral promotional regimes), which considerably reduced or even led to negative effective protection of many producers of industrial inputs or capital goods.

In turn, exchange rate policy —which often provides for fixed nominal exchange rates or controlled devaluations— usually accentuates the biases of trade policy. Added to this are variations in the rules concerning the capital account of the balance of payments, whose net results are fluctuations in the real exchange rate, lack of incentives for the production of exportables and —compounded by other factors— macroeconomic instability, whose best-known manifestation in Latin America has been high inflation.

Some countries have tried to turn this situation around by adopting packages of measures that could be conventionally described as fiscal and structural reforms of the price system (especially trade liberalization and deregulated, more flexible treatment of foreign capital). In several of the cases considered, such reforms were the backbone of policy packages to stabilize prices and revive production.

Chile's trade liberalization is the most long-standing and continuously applied reform in the region. In late 1973, before the reforms were introduced, nominal tariffs averaged 94%, with dispersion ranging from 0 to 750%; countless non-tariff restrictions were applied; and a complicated system of multiple exchange rates was in force (Ffrench-Davis, Leiva and Madrid, 1991; Meller, 1993) (see box V.1).

The more pragmatic approach to trade policy that emerged in Chile in 1982-1983 has been extended to policies on exchange rates and the capital account of the balance of payments. Since the late 1980s, Chile has received a renewed inflow of foreign capital. During the first trade liberalization exercise (1974-1981), the authorities allowed a prolonged appreciation of the exchange rate linked to an increasingly liberal policy on inflows of private capital; since 1989, in contrast, they have tried to contain appreciation to protect the momentum of production in tradable sectors. In particular, reserve requirements and taxes have been imposed on foreign financial loans. These policies have curbed the real exchange rate's appreciation which began in 1988 and threatened to intensify in 1991-1992.

Some have concluded from the Chilean experience that the second trade reform (1985-1991) has yielded more positive results than the first. In the earlier period, significant tariff cuts and the dismantling of quantitative restrictions gave exports a bigger boost than did the modest tariff reduction implemented during the second period, since the first trade reform took place in a situation with plenty of room for cutting costs by substituting imported inputs for domestic ones, and with ample opportunity for bringing about changes in relative profitability rates. However, given the context of recession in which the reforms were implemented, their rapid introduction and the behaviour of the exchange and interest rates, increased foreign sales were achieved at a high cost, and the export sector's dynamism was not transmitted to the rest of the economy; thus, per capita GDP (between the maximum levels for 1974 and 1981) expanded at less than 1% a year, investment fell far below its past levels and an intensive de-industrialization process took place[44] (see table V.2).

Since 1984, the economy has first experienced a recovery and then sustained growth based on the expansion of the supply of exportables in non-traditional sectors. However, the dynamism of non-traditional exports is not primarily attributable to the tariff reduction, since the drop was very moderate, and drawback mechanisms were available to exporters.

During the second period, exchange rate depreciation was primarily responsible for the success of Chilean exports; it should be recalled that the real exchange rate more than doubled between 1981 and

44 For a more detailed account, see Ffrench-Davis, Leiva and Madrid (1991).

Box V.1

CHILE: DIFFERENCES BETWEEN TWO TRADE REFORMS

Since trade reform has a long history in Chile, reliable lessons regarding its effects can be drawn from that country's experience. It is essential to bear in mind that Chile actually implemented two trade reforms: a radical one in 1974-1979 and a more moderate one in 1985-1991. Although the trade policy of abolishing non-tariff barriers and using a uniform tariff has not been changed since 1979, tariffs had returned to relatively high levels by 1984 and were accompanied by measures to guard against unfair competition and by price bands for certain agricultural products. Indeed, the average tariff of 20% in 1984-1989 was twice the level of 1979-1982. But the basic difference between the two periods is that the exchange rate appreciated steadily, following an initial depreciation, during the first liberalization experiment. In the 1980s, conversely, the tariff cut from a maximum of 35% in September 1984 to the current level of 11% in June 1991 was accompanied by a sharp real devaluation (associated with the debt crisis), which sent positive signals to exporters and, at the same time, more than offset the slightly negative impact of the tariff reduction on the production of goods that competed with imports. For this reason, the second period was marked by more sustained growth of non-traditional exports and a significant recovery of the production of import substitutes, mainly between 1984 and the end of the 1980s.

In evaluating Chile's two trade reforms, it is interesting to note the performance of capital formation and the industrial sector. Although gross fixed capital formation and capital productivity increased once the crisis of the early 1980s was over, the fixed-investment coefficient was far below its levels of the 1960s; only in 1993 did this coefficient exceed its average in that decade. The economy's inability to surpass that level of investment kept it from attaining a significant growth rate between 1974 and the end of the 1980s, during which time cumulative growth averaged less than 2.5% a year.

In the first period of trade liberalization, the economy was significantly de-industrialized, as shown by five percentage points decline in the share of manufactures in GDP. Many potentially strong manufacturing firms failed as a result of the particular combination of trade and exchange rate policies in force at that time.

Despite the successes of the second period, the de-industrialization process fostered by the first reform has not been reversed. Exports remain concentrated in natural resource-intensive categories. However, products with higher value added have been gaining ground, investment has continued to recover and the creation of new productive capacity, though recently begun in the 1990s, has started to expand at a sustainable rate that is significantly higher than the rate recorded in the 1960s.

Source: R. Ffrench-Davis, P. Leiva and R. Madrid, *Trade Liberalization in Chile: Experiences and Prospects*, Trade Policy series, No. 1 (UNCTAD/ITP/68), New York, United Nations Conference on Trade and Development (UNCTAD), 1991. United Nations publication, Sales No. E.91.II.D.18; M. Agosin and R. Ffrench-Davis, "Trade liberalization in Latin America", *CEPAL Review*, No. 50 (LC/G.1767-P), Santiago, Chile, August 1993.

1988. Also, the participation of foreign direct investment (FDI) in these exports has been crucial. Owing to this process of change in the Chilean economy, exports have come to represent a substantially larger share of GDP —more than 30% in recent years (see table V.2).

The authorities' persistence in sustaining the reform process has led to changes in production patterns involving a reorganization of the sectoral structure. However, the unique features of this experience in Chile make it difficult to reproduce in other circumstances, particularly in view of the length of time it required and its initially high economic and social costs.

Two other experiences of simultaneously liberalizing trade and capital movements took place in Argentina in 1976-1981 and Bolivia since 1985.

In 1976, the Argentine Government launched a trade reform that was later accompanied by unrestricted financial liberalization and, subsequently, an

Table V.2
CHILE: SELECTED INDICATORS OF THE GROWTH PROCESS, 1961-1992 [a]
(Percentages)

	1961-1971	1971-1974	1974-1981	1981-1989	1989-1992
Growth rates/GDP	4.7	0.3	2.6	2.3	6.0
Real exports [b]					
Total	3.4	9.1	7.1	8.5	10.9
Non-copper	4.7	8.5	12.8	11.5	13.4
	1961-1970	1971-1973	1974-1981	1982-1989	1990-1992
Average share					
Gross fixed investment/GDP	20.2	15.9	15.7	15.2	19.1
Manufactures/GDP	25.4	27.2	22.0	20.5	20.6
Exports [c]/GDP	12.0	9.9	20.2	27.0	32.4

Source: Calculated on the basis of figures from the Central Bank of Chile and R. Ffrench-Davis and O. Muñoz, *Desarrollo económico, inestabilidad y desequilibrios políticos en Chile: 1950-1989*, Colección Estudios CIEPLAN, No. 28, Santiago, Chile, Economic Research Corporation for Latin America (CIEPLAN), June 1990.
[a] At 1977 prices. [b] Exports of goods. [c] Exports of goods and services.

anti-inflation policy based mainly on control of the exchange rate. At that time, the Argentine programme was similar in some respects to Chile's programme of the 1970s. In 1976-1978, the authorities took the initial steps of removing non-tariff barriers and slashing tariffs (from 94% to 44%, on average). At the same time, they put into effect a compensatory devaluation. As in Chile, the objective of structurally adjusting the economy in the direction of greater internationalization of the production system was gradually replaced with that of lowering inflation through exchange rate lags; this was facilitated by financial liberalization and abundant liquidity in international financial markets. In 1979 and 1980 a policy was implemented to appreciate the real exchange rate through nominal devaluations that were lower than the rate of inflation. As a result, the decline in the average tariff from 44% to 35% was accompanied by a real exchange rate appreciation of over 30%. As in the case of Chile —though one year before the external debt crisis became widespread in the region—, the disappearance of external credit to finance the growing current-account imbalance forced the authorities to discontinue the programme.

In recent years, Argentina has carried out a second liberalization experiment. Beginning in October 1988, a notable trend towards trade liberalization emerged, as a surcharge was eliminated and a new tariff regime was introduced. In the period between the adoption of those measures and the reforms of April 1991, 11 successive tariff cuts were implemented. The process of trade and financial liberalization culminated in the adoption of a package of measures that included a law on convertibility, a total opening of the capital account and a consolidation of trade reform.

The programme has been highly successful in terms of restoring certain macroeconomic balances, drastically reducing the country's spiralling inflation and generating more optimistic expectations. The introduction of a fixed nominal exchange rate has translated into a real appreciation of the peso, which has been validated by a large inflow of foreign capital. Protection for producers of tradables has declined considerably, owing both to

the tariff reductions and the dismantling of non-tariff barriers and to the extraordinary appreciation of the peso. Industry has suffered a decrease in profitability in both domestic and foreign markets. However, as long as favourable business expectations are reflected in greater investment and gains in efficiency and productivity, these effects may progressively neutralize the decreased profitability of tradable sectors. In fact, GDP is showing a vigorous recovery that has already lasted three years.

In 1986, Bolivia also launched an ambitious trade liberalization programme, which is still in force as part of the country's plan to stabilize and reorder its economy to conquer hyperinflation and restore growth (Morales, 1992).

Prior to the introduction of the liberalization programme, tariffs were highly dispersed, with a maximum level of 150%. Import bans and licence requirements were also in force. The authorities began by unifying the exchange rate, returning to total convertibility, scrapping quantitative restrictions and cutting tariffs. They also opened up the capital account almost completely. Since then, the real effective exchange rate has undergone significant devaluations (see table V.1).

Bolivia simplified its tariff system in 1986 by establishing a single tariff of 20%. In 1990 the tariff was reduced to 5% for capital goods and 10% for other goods; these levels have been maintained to date. Bolivia now has one of the most open economies in Latin America and in the world.

The reform succeeded in its aim of stabilization, but the expected recovery of economic performance has been elusive: since hyperinflation was quelled in 1986, the Bolivian economy's growth rates have been modest, especially in comparison to those of the 1970s. Investment as a proportion of output has fallen in the years following the reforms.

Along with the drastic reduction of inflation, one positive change has been the diversification of exports, though they remain concentrated in mineral and agricultural products and their total amount still falls short of the levels reached in the early 1980s.

Bolivia's experience suggests that, in an economy with little diversity and low productivity, a reform that changes market signals in order to align national prices with international ones, though necessary, is insufficient to fuel a rapid process of structural change with growth.

b) Experiences with high compensatory trade incentives prior to liberalization

The experiences of other countries of the region differ from those described above. In these economies, high levels of protection have been maintained for long periods, but at times their distortionary effects on relative prices have been offset, at least partly, through the adoption of various export incentives (such as drawbacks, special import regimes, tax exemptions and preferential financing for exporters).

Certain limitations, both domestic (especially fiscal constraints) and external (various reactions on the part of trading partners), have narrowed the margins for the concession of export incentives. At the same time, the recognition of the benefits of access to imports and the successful experiences of some developing countries have prompted a proliferation of trade liberalization processes since the end of the 1980s. This shift towards liberalization in recent years has been observed even in countries that historically have opted to keep import barriers in place while neutralizing their effects on the export sector.

From the 1960s up to 1988, when the reforms began to be intensified, Brazil had a trade and exchange rate regime with three main features: a highly restrictive import policy managed through import licences and bans, which were an essential component of industrial policies; active export promotion, including fiscal incentives, various lines of financing and drawbacks on imported inputs (Baumann and Moreira, 1987); and a crawling peg which, except for brief periods, avoided the overvaluation and excessive fluctuations of the real exchange rate that characterized other

countries in the region (Fritsch and Franco, 1993). This last factor led to good export performance despite the Brazilian economy's high inflation.

Trade policy was closely linked to sectoral industrial policies led by entities that included business associations in each sector. Another salient feature of the Brazilian trade system was the neutralization of the widespread anti-export bias of protectionist policies through hefty subsidies for the exports of favoured industries. In addition to these fiscal incentives, some manufactures exporters enjoyed access to inputs and capital goods imported under special programmes, in exchange for a commitment to export and to maintain a positive balance in the use of foreign exchange.

In 1985 the country initiated partial reforms of its trade policy. Tariffs were successively reduced beginning in 1988, and in 1990 a programme to deepen trade liberalization was launched. Subsequently, quantitative controls were dismantled, after which external trade was reformed and its administration simplified.

In 1991 Brazil announced a new timetable for tariff reductions —which brought tariffs to an average of 14% in mid-1993— and the elimination of various export incentives. Another important change, introduced in 1990, consisted of complementing the crawling peg with a "dirty float" regime for current international transactions.

Until the early 1990s, Colombia's trade policy combined an import substitution regime (based on high, differentiated tariffs and import licencing requirements) with a system of promoting non-traditional exports through subsidies and drawbacks, intended to moderate the anti-export bias of import policies. The high tariffs were accompanied by a complex system of prior licencing, although certain sectors were governed by special regimes that lowered the amount of duty actually paid. The various attempts to liberalize external trade in recent decades did not alter the essential features of the prevailing regime (Ocampo and Villar, 1992a).

Colombia, as early as the 1960s, became the second country, after Chile, to adopt a crawling-peg regime based on strict exchange rate controls. Colombia launched its trade reforms in 1990, after its currency suffered severe real devaluations beginning in 1985, which stimulated a large increase in exports other than coffee. In the first phase of the reform, quantitative restrictions were removed, although their protectionist effect was replaced with that of higher tariffs and exchange rate devaluations. Subsequently, tariffs were lowered.

The trade liberalization process came to an end in Colombia in early 1992. Average nominal protection had decreased to 12%, compared to 44% in early 1990, and effective protection of domestically-produced goods had fallen from 91% to 29%. The degree of tariff dispersion had also been drastically reduced (Ocampo, 1993, p. 17).

In the financial sphere, a series of measures was imposed to halt the trend towards exchange rate appreciation (Cárdenas and Barrera, 1993). In practice, the system is still regulated to a significant degree by the Banco de la República.

In 1985, Mexico implemented a programme to liberalize imports and gradually dismantle the traditional instruments of industrial policy. It should be noted that liberalization in that country was preceded and followed by sharp depreciations of the real exchange rate (in 1982-1983 and 1986-1987), which gave the industrial sector a significant buffer that helped it make the adjustment (Ten Kate, 1992). These pronounced devaluations were necessitated by the fiscal and balance-of-payments crises touched off by the suspension of foreign credit (in 1982) and the drop in oil prices (in 1986-1987).[45]

45 It should be recalled that in Mexico, as in Chile, devaluations contributed to fiscal equilibrium, since earnings from the main export product are an important source of tax revenue and turn the public sector into a net supplier of foreign exchange.

Before liberalizing its trade, Mexico used a wide variety of instruments to control imports, stimulate industrial production and orient the manufacturing sector towards markets abroad. Local production was protected not only by a highly dispersed tariff structure with a ceiling of 100%, but also by import permit requirements (affecting 92% of foreign purchases) and the use of officially appraised values that were higher than purchase prices (affecting 19% of imports).

Exporters of non-traditional goods enjoyed tax breaks, which partially offset the anti-export bias of trade policy. In addition, for many years Mexico successfully used industrial promotion programmes to boost import substitution in sectors considered strategic, sometimes in conjunction with export promotion programmes (Ros, 1993).

The trade liberalization programme began in 1985 with the removal of quantitative restrictions on a large number of tariff items. Liberalization focused primarily on intermediate and capital goods, and more selectively on certain consumer goods. At first, tariffs were raised to compensate for the elimination of direct controls. In 1987, the authorities deepened the trade reform by abolishing the prior-authorization requirement for many imports of consumer goods, discontinuing the officially appraised values still in use and simplifying tariffs by reducing them to five rates ranging from 0 to 20%, with an average of 12% (weighted by production) or 6% (weighted by imports).

Trade reform has been extended to exports, with the elimination of permit requirements for many of them. The remaining quantitative restrictions on exports are determined on the basis of price controls (for some agricultural products) and bilateral or international agreements. Traditional export-subsidy instruments have been eliminated, partly as a consequence of Mexico's accession to GATT and its bilateral negotiations with the United States.

The use of industrial incentive policies has also been significantly reduced. The remaining programmes, which still include quantitative restrictions on imports, are concentrated in only a few specific sectors, such as the automotive and microcomputer industries.

The sharp real devaluations of 1986 and 1987 enabled the Government to launch the Economic Solidarity Pact, which froze the exchange rate, deepened trade liberalization and moderated wages in an attempt to reduce annual inflation to single-digit levels; this goal was achieved in 1993.

Mexico's manufactures exports are growing rapidly, and the industrial sector's share of GDP has risen slightly. However, the growth rates for the economy as a whole have been modest in the period following the reforms (see table V.3).

c) Experiences involving subregional agreements and structural adjustment programmes

Trade liberalization programmes run into special difficulties when they coincide with subregional integration processes that include the adoption of a common tariff, unless all the participating countries agree to cut tariffs simultaneously. This, however, is not always the case, as shown by the example of Costa Rica and Guatemala.

These two countries effected a gradual, three-stage reduction in their levels of protection between 1986 and 1993. In both countries, trade liberalization was combined with significant real devaluations and with some recovery of industrial production linked to the expansion of intra-Central American trade. This cushioned the potentially negative impact of trade liberalization with respect to third countries. Although both countries began the liberalization process at the same time — under a reform of Central America's common external tariff in 1986— their paths subsequently diverged as a result of Costa Rica's prior multilateral commitments to structural adjustment and trade liberalization. However, in 1993 the two countries' tariffs converged towards equivalent levels.

Table V.3
MEXICO: SELECTED INDICATORS OF THE GROWTH PROCESS, 1980-1992 [a]

Years	Growth rate of GDP (%)	Fixed investment/ GDP (%)	Manufactures/ GDP (%)	Non-oil exports (billions of dollars)		
				Goods	Maquila services	% of total exports[b]
1970-1979	6.5	23.4	22.8	..	..	85.9
1980	9.2	24.8	22.1	6.0	0.8	40.0
1985	2.6	17.9	21.4	6.9	1.3	35.6
1986	-3.8	16.4	21.0	9.7	1.3	63.6
1987	1.9	16.1	21.3	12.0	1.6	61.8
1988	1.2	16.8	21.7	14.1	2.3	71.3
1989	3.3	17.3	22.5	15.0	3.1	69.9
1990	4.4	18.7	22.8	16.9	3.6	67.4
1991	3.6	19.5	22.9	18.9	4.0	74.4
1992	2.6	21.7	22.7	19.5	4.7	75.1

Source: ECLAC, Preliminary overview of the economy of Latin America and the Caribbean, 1992 (LC/G.1751), Santiago, Chile, December, 1992; *Statistical Yearbook for Latin America and the Caribbean, 1992 Edition* (LC/G.1747-P), Santiago, Chile, March 1993. United Nations publication, Sales No. E/S.93.II.G.1; and J. Ros, La reforma del régimen comercial en México durante los años ochenta: sus efectos económicos y dimensiones políticas, Reformas de política pública series, No. 4 (LC/L.743), Santiago, Chile, ECLAC, April 1993.

[a] Based on figures in dollars, at constant 1980 prices. [b] Share of non-oil merchandise exports plus maquila services in total merchandise exports plus maquila services.

Prior to 1986, Costa Rica and Guatemala had average (unweighted) nominal protection levels of about 50%, with higher rates of up to 100% for consumer goods, and lower levels or exemptions for inputs and capital goods. In general, both countries' markets had been more open than those of other countries in the region, in terms of imports as a proportion of GDP or the level of effective protection (Rapoport, 1978); historically, non-tariff barriers had not —except for short periods, such as 1982-1984 in Guatemala— been very important in either country.

The first tariff reform carried out simultaneously by the two countries, in 1986, was basically intended to rationalize protection. As part of this reform, the countries eliminated exemptions applied to imports of inputs and capital goods, which had significantly increased effective protection. They also did away with the surcharges agreed upon by all the Central American countries, and reduced the highest tariffs; these measures brought average nominal tariff protection down from 50% to about 25% in both countries, with less dispersion as well.

These reforms do not seem to have had significantly adverse effects on productive activities. First, the tariffs had contained "water"; i.e., they were so high that producers had not deemed it advisable to make full use of them, considering domestic demand. Second, devaluations took place in both countries: in 1986, Guatemala's real exchange rate[46] depreciated some 42%, whereas Costa Rica's depreciated 7% that year and another 10% the following year.

Levels of tariff protection in Costa Rica and Guatemala began to diverge in 1987, when the former launched a second tariff-reduction programme in accordance with its commitments under a structural adjustment programme agreed upon with the World Bank, which was partially strengthened by the concessions made as part of Costa Rica's accession to GATT in 1990. The country agreed to cut its tariffs to an average level of 20% by 1990, while it continued to reduce tariff dispersion and eliminated a domestic surcharge which it

46 Exchange rate weighted by the relative prices of the main trading partners.

had justified as being an instrument for defending the balance of payments. This tariff reduction process was accompanied by a gradual depreciation of the real exchange rate between 1987 and 1990 as a result of the adoption of a crawling-peg regime.

In 1990 Guatemala carried out a later but faster reduction of nominal tariff protection by reducing its average level to 19%, also in relation to the prospect of structural adjustment agreements and entry into GATT, which took place in 1991. However, the effect of the greater reduction of protection against importable products was neutralized by a sharp devaluation in the form of a 17% depreciation of the real exchange rate in 1990.

In general, the steep devaluations experienced in Guatemala in 1986, 1987 and 1990, as well as the more gradual depreciation in Costa Rica, created especially favourable conditions for the production of tradable goods and services. This cushioned the negative effects of a third phase of protection-reduction, undertaken by both countries in 1992 and 1993, despite the appreciation of the real exchange rate in Guatemala in 1991 and in Costa Rica in 1992 and 1993. Moreover, the inflow of capital and the appreciation of the two countries' currencies, together with the economic recovery observed in both 1992 and 1993, helped to boost intra-Central American trade, thus enabling the industrial sector to expand despite the reduction of protection.

The third stage of tariff reduction culminated in equivalent tariffs in Costa Rica and Guatemala, with a maximum of 20% for finished goods and a minimum of 5% for inputs and capital goods. Guatemala's entry into GATT, which was more recent than Costa Rica's, involved greater tariff concessions: whereas Costa Rica's tariffs were consolidated at 45%, Guatemala's were consolidated at 60%. The tariff reductions made by other Central American countries with similar structural adjustment agreements facilitated the conclusion of an agreement on a new common external tariff in 1993, with the same margins of 20% and 5%.

Two lessons can be drawn from the comparative experiences of Costa Rica and Guatemala, which are illustrative of integration agreements between two or more countries. First, they confirm the desirability of reducing protection gradually, with a clear sense of direction, and of combining it with a gradual depreciation of local currency in real terms. Costa Rica demonstrates that this can be achieved with a crawling peg, while Guatemala's experience indicates that, although devaluations can offset the effect of reducing protection, the exchange rate can become extremely volatile in the absence of a policy based on either a crawling peg or a clearly defined parity. The combination of gradualness on the one hand, and a clear direction on the other, is probably the main reason why Costa Rica has had one of the highest investment coefficients in Latin America since 1987.

Second, both countries' experiences illustrate the complex relationship between international and subregional trade liberalization agreements. In particular, the international commitments made under structural adjustment programmes can be decisive, by promoting both the abandonment of a common external tariff (CET) agreed upon at the subregional level and a convergence that creates favourable conditions for agreeing on a new CET. In turn, a CET could lend more credibility to national trade liberalization processes, since it can serve to consolidate or "lock in" tariff reductions through the joint commitment of several countries (ECLAC, 1994a).

2. Export promotion policies

Export promotion policies have been used as a complement to tariff liberalization, as an integral part of trade policy. This section compares the various mechanisms used in the past two decades to promote exports in nine countries of the region (Argentina, Brazil, Chile, Colombia, Costa Rica, Guatemala, Mexico, Paraguay and

Uruguay), in order to describe the practices adopted in those countries, observe the trends that have emerged over time and, whenever possible, compare these two elements with their equivalents in other regions.

A review of the structures of export incentives in the nine countries, from the standpoint of changing production patterns, suggests that, in general, the region suffers from several weaknesses in this sphere.

The most common incentives relate to access to imported inputs and tax exemptions on domestic value added. Export policies are generally defined in strictly commercial terms, and few countries provide incentives for improving the exportable supply and access to foreign markets through promotion, marketing, quality and trademark differentiation activities, or the creation of export trading companies (all of which characterize the aggressive trade strategy of the Asian countries) or the signing of export contracts, with incentives differentiated according to commitments on exported value, another key feature of the Asian experiences. Something similar occurs with the promotion of investments abroad in marketing and participation in wholesale distribution chains, all of which are important for promoting the globalization of production.

a) Fiscal incentives

Comparative analysis of fiscal incentives in nine countries of the region shows the following (see table V.4):

i) The most common instruments for stimulating exports are fiscal (tax exemptions or drawbacks) rather than financial. Argentina, Brazil and Colombia have applied various kinds of incentives since the 1960s; other countries, such as Guatemala, have adopted them more recently.

ii) During the second half of the 1980s, and concurrently with the import liberalization process, several of these instruments were eliminated, such as the exemption from tax on profits and the incentives subject to export performance (in Argentina and Brazil), and the exemption from indirect taxes other than value-added tax (VAT) (in Mexico).

The reasons for these changes vary. In some cases, it was simply that the structure of incentives had to be adapted to conditions agreed to in the framework of GATT; in others, as in the case of Mexico, the prospect of signing a bilateral trade agreement required their elimination. Lastly there were fiscal reasons, and reasons of efficiency in terms of effectively stimulating the export sector, or other reasons deriving simply from the more general desire to reduce the presence of public policy.

iii) The most commonly used instruments relate to preferential access to imported inputs (drawbacks) and exemption from domestic VAT. These correspond to a minimum level of export promotion, i.e., the elimination of barriers to imports of inputs and the non-taxation of exportable products.

iv) The differences observed among the various countries concern their respective domestic fiscal structures (for example, the existence of indirect taxes)[47] and the composition of their exports: only two of the nine countries grant incentives to export trading companies.

v) Incentives subject to export performance, applied traditionally in Colombia and introduced more recently in Mexico, have been eliminated in recent years in Argentina,[48] Brazil[49] and Costa Rica as part of their economic reforms.

b) Financial mechanisms

International conditions are decisive for export financing policies, since the industrialized countries have tried to regulate competition as regards the financing terms offered and reducing the degree of subsidy implicit in those terms. The

47 Or the non-existence of an income tax, as in Uruguay, for instance.

48 This kind of incentive has been reintroduced for the automotive industry.

49 They exist only in the case of some contracts signed before 1990.

Table V.4

LATIN AMERICA (SOME COUNTRIES): SUMMARY OF FISCAL INCENTIVES FOR EXPORTS (1992)

Incentives	Argentina	Brazil	Chile	Colombia	Costa Rica	Guatemala	Mexico	Paraguay	Uruguay
Rebates	Levels similar to tariffs (new manufactures)	No	Levels similar to tariffs	No	Yes	Yes	Include indirect exports	No	No
Tax credit certificates	No	No	No	Excludes traditional products	Up to 30% of exported value	No	No	No	No
Drawbacks	Refund of import duties and charges (1960)	Refund of import duties and charges (1964)	Refund of import duties and charges (1988)	[a]	Refund of import duties and charges (1972)	Refund of export duties and charges (1983)	Refund of import duties and charges (1972)	Mechanism planned but not operative	Refund of import duties and charges
Exemption from value-added tax	Includes credit for pre-export stages	Includes credit for pre-export stages (1964)	Since 1975	[b]	No	Yes	Includes credit for pre-export stages	Includes credit for pre-export stages	Includes credit for pre-export stages
Exemption from other indirect taxes	Includes indirect exporters	Benefits industrialized products	No	Excludes some products	No	No	Until 1985	Yes	Up to 10% of exported value
Exemption from tax on profits	Existed between 1985 and 1989	No	No	No	Non-traditional products	Non-traditional products	NO	Yes	No
Incentives subject to export performance	Existed between 1986 and 1993[c]	Existed between 1972 and 1990	No	Since 1959	Since 1972[d]	No	Since 1986	No	No
Incentives for export trading companies	Since 1985 (not operative)	Since 1972[e]	No	No	No	No	Since 1986	No	No

Source: ECLAC, on the basis of official data.

[a] The facilities provided for in the Vallejo Plan are classified as incentives subject to export performance. [b] The exemption through tax rebate certificates (CERT) is classified as a tax credit certificate. [c] Reintroduced for the automotive industry. [d] Not subject to export contracts; incentive proportional to the amount exported. [e] The same incentives as are given to other exporters.

member countries of the Organisation for Economic Cooperation and Development (OECD) have explicit mechanisms in this area,[50] defining parameters on which other countries base themselves. New private sector credit instruments[51] are also on the rise, making export credits increasingly common in countries where financial and insurance markets operate without major restrictions.[52]

In Latin America, the financing of external sales has been essential for expanding and diversifying non-traditional exports. Empirical evidence shows a strong positive correlation between the availability of export financing and the relative increase in exports of non-traditional products (especially manufactures) among total exports (Rhee, 1989).

The export financing mechanisms of countries of the region have traditionally involved the direct or indirect use of public resources: i) financing by government agencies; ii) reimbursement of paper bought back from exporters; iii) refinancing, at preferential rates, of credits granted by the private system to exporters; iv) coverage of the difference between market interest rates and fixed rates set at a lower level, in order to promote exports; and v) provision of insurance and credits, especially for financing granted to foreign buyers.

In virtually all these mechanisms, commercial banks play a key export financing role in most countries of the region. Since there are no parallel insurance policies, especially for pre-shipment credits, effective access to credit is limited to those exporters who can offer guarantees, to the detriment of most small and medium-sized enterprises.

A second consequence is that, in most countries of the region, financing is concentrated on final exporters. There are few mechanisms benefiting the domestic suppliers of inputs to the export sector. Third, because of the limitations of the domestic capital market, especially as regards long-term credit, the short-term loans characteristic of commercial banks limit the financing of fixed capital investment for export activities and the post-shipment financing of capital goods and other products, thereby jeopardizing the goal of export diversification.

This suggests that an appropriate export financing policy should include: i) mechanisms for providing access to credit; ii) insurance systems to enable firms with fewer guarantees for pre-shipment financing to obtain credit; iii) mechanisms for providing long-term credit lines; and iv) the necessary insurance structure to cover post-shipment risks.

Table V.5 summarizes some of the financial incentives provided for exports in the nine countries studied.

The most marked differences among the various financial incentive structures can be seen in the credit lines additional to supplier's credits and in financing for the production of exportable goods. For example, not all countries have specific lines of financing for trade promotion or for investments by exporters in fixed assets, nor do they have mechanisms that facilitate access to financing for agents involved in the various stages of the production process. These are areas in which the high risk of export activities and the time periods involved generally require inputs of government resources or lines of financing from international bodies. Even so, this does not eliminate the bias against small

50 Since 1978, the OECD countries have had an Arrangement on Guidelines for Officially Supported Export Credits.

51 For example, "forfeiting" (a private system of credit for buyers that enables exporters to obtain post-shipment financing and medium-term discount notes) and "securitization" (a mechanism enabling groups of small enterprises to obtain pre-shipment credit by reducing individual risk), among others.

52 In some industrialized countries, official support for exports is limited to providing insurance and guarantees.

Table V.5

LATIN AMERICA (SOME COUNTRIES): SUMMARY OF FINANCIAL INCENTIVES FOR EXPORTS (1992)

Incentives	Argentina	Brazil	Chile	Colombia	Costa Rica	Guatemala	Mexico	Paraguay	Uruguay
Pre-shipment credit									
a. Public resources	Existed from 1963 to 1991	No	For some products	Since 1967	Since 1983	For some products	Since 1985		Since 1985
b. Private resources	Market conditions		Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions
Post-shipment credit									
a. Public resources	Existed from 1965 to 1991	For some products	For some products	For some products	Since 1983	For some products	For some products		
b. Private resources	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions	Market conditions
Trade promotion	Only for small and medium-sized enterprises (FOPEX resources)	No	Sercotec- CORFO credit line	Since 1967	No	No	Since 1985	No	No
Fixed asset financing for exporters	No	No	No	% varies according to export/sales ratio	Since 1983	Yes	Since 1985	No	No
Financing for development of exportable goods	No	No	Sercotec- CORFO credit line	Since 1967	Yes	No	Since 1985	No	No
Export letter of credit	No	No	No	No	No	No	Since 1985	No	No
INSURANCE: Pre-shipment financing	Private insurers	No	Private insurers	Private insurers	No	No	BANCOMEXT guarantee since 1987	No	No
Post-shipment financing:									
a. Commercial risk	Private insurers	Private insurers	Private insurers	Private insurers	No	No	BANCOMEXT guarantee	Private insurers	Private insurers
b. Extraordinary risk	Treasury resources	Treasury resources		Existed until 1986	No	No	BANCOMEXT guarantee	No	No
c. Exchange rate risk	No	No	No	No	No	No	No	No	No

Source: ECLAC, on the basis of official information.

and medium-sized enterprises or the difficulty of benefiting indirect exporters.

The lower part of table V.5 shows that export credit insurance is in short supply. In all the countries, except Mexico since 1987, private insurance companies cover pre-shipment financing, as well as commercial risks in the post-shipment stage. These countries have no established mechanisms for covering exchange rate risks, and often there is no coverage against extraordinary risks. Given the limitations on access to the main financial markets, it is often difficult to obtain reinsurance, which would enable insurers to diversify their securities portfolios.

To sum up, the present structure of fiscal and credit incentives for exports in Latin America seems to still pursue the basic objective of promoting the diversification of exportable supply. By contrast, relatively little attention is paid to the systemic nature of competitiveness. There are still too few incentive mechanisms that cover all the various stages of the production process.[53]

For purposes of comparison, tables V.4 and V.5 present only those incentives that are similar in a number of different countries. A descriptive analysis, however, should at least mention other existing mechanisms, some of which have had clearly positive effects on the export sector, while other, more recent ones, have been welcomed by the various agents. These include: i) stimuli deriving from the more efficient use of trade promotion services in diplomatic missions and from easier access to information and more streamlined procedures through the integrated computerized system for foreign trade (SISCOMEX[54] in Brazil) and random customs selections (Mexico); ii) incentives granted in exchange for export value or volume commitments (Commission for the Granting of Fiscal Benefits to Special Export Programmes (BEFIEX) in Brazil, Vallejo Plan in Colombia, Programme of Coordination with Major Export Enterprises (ALTEX) in Mexico); iii) mechanisms such as the Export Card (Mexico), which gives the various agents involved in production and export processes easy access to domestic credit; iv) credit lines not included in table V.5, such as those for financing the export of services, the export of turnkey production plants, the acquisition of storage facilities abroad, the conduct of market surveys, and the shipment of commercial samples (Argentina, Brazil, Colombia); and v) other kinds of incentives, such as temporary admission, administrative facilities and differentiated customs treatment for warehoused exportable products, and experiments such as the Chile Foundation, a semi-public organization that carries out projects for developing new exportable products and, after their economic viability has been demonstrated, sells them to the private sector by tender (see box V.2).

c) Promotion mechanisms not based on prices

i) *The institutional structure of export policies.* Policies providing institutional support for exports vary as to the level of decision-making involved in the different countries of Latin America. In some countries (Mexico, Guatemala, Colombia, Paraguay, Brazil between 1965 and 1990), overall guidelines are defined by ministerial governing councils specifically in charge of foreign trade,[55] while in

53 Some exceptions are financing that has an impact on supply, such as credit lines for exports of consultancy and engineering services and capital goods, and financing for enterprises with export potential and programmes to develop exportable supply.

54 SISCOMEX has considerably simplified export and import red tape by replacing various documents, while permitting computerized integration of the activities of the main agencies involved in foreign trade.

55 In some countries (such as Costa Rica since 1986), there are specific ministries for foreign trade, while in others —the majority— foreign trade is handled by agencies linked to the Ministries of Finance, Industry, Trade or Agriculture.

Box V.2

THE CHILE FOUNDATION

The origins of the Chile Foundation go back to the nationalization of the Chilean Telephone Company, a subsidiary of ITT, during the Government of Salvador Allende. Under the following Government, as part of a compensation agreement, the Chile Foundation was created as an activity in which each of the two parties would invest an initial capital of US$ 25 million for a joint operation. The idea was that the Foundation could gradually become self-supporting by providing services to the private sector and establishing lucrative production companies that used new technologies.

The Foundation's first projects were directed mainly at improving the quality of processed fruit and vegetables and providing technical assistance to the edible oil industry, including methods for refining fish oil and using other by-products.

Few of these early projects got beyond the exploratory stage. In view of this problem, the Foundation decided to acquire experience by launching business projects itself.

The idea was to determine which activities might benefit from new technologies, and then to acquire and adapt these technologies. Once a technology was assimilated, the Foundation would take charge of commercial production and marketing through a subsidiary. When the subsidiary became profitable, it would be sold, thereby completing the technology transfer process. The Foundation set up more than 20 subsidiaries in this way, mainly in the agricultural and fisheries sectors.

Salmon farming was a very successful example. In 1981, the Foundation decided to carry out a pilot project for farming salmon in cages in fresh water. Various technical problems related to feeding the fish, controlling disease, changes in currents and water temperature, handling of eggs and fry, selection of species and the behaviour of the fish in the cages were solved during the project's execution.

Commercial production began in the period 1986-1987, and output doubled in the following period. The project began to make a profit in 1988, and the transfer cycle was completed that year when the Foundation sold the project to a Japanese edible fish and shellfish company.

The Foundation's salmon farming project gave definite impetus to overall salmon production in Chile, which increased from 94 tons in 1983 to over 4,000 tons in 1988. The technological capacity developed within the Foundation was so great that it was able to provide technical assistance to more than half the new projects.

Source: T. Huss, "Transfer of technology: the case of the Chile Foundation", *CEPAL Review*, No. 43 (LC/G.1654-P), Santiago, Chile, April 1991.

others, foreign trade is the province of one (Argentina) or more (Brazil) secretariats linked to ministries in the economic area. There are also differences as to the kinds of agencies that administer foreign trade policy: in Mexico and Colombia there are foreign trade banks with powers in the area of financing policy and credit insurance for exports, while in other countries these functions are performed by non-banking agencies that essentially administer budgetary resources (Brazil), or there simply is no centralized policy for intervening in commercial activity, but instead a development and promotion body (Chile).

Other differences concern the degree of participation by private agents in the formulation of foreign trade policy. In some countries (Mexico, Colombia, Brazil until 1990), such participation is constant, and takes the form of representation of producers' organizations in the ministerial governing councils for foreign trade and other specific commissions. In other cases, the private sector participates indirectly through sectoral bodies (such as the sectoral chambers in Brazil since 1990) or consultative bodies, such as the Foreign Trade Council in Chile, in existence since 1990.

Generally speaking, the bodies that support Latin American exports have con-

centrated more on promoting trade than on influencing the conditions of supply. There are few cases in which incentives have been provided for creating export trading companies, intensive use has been made of the facilities of diplomatic missions for trade purposes, or trade representation offices have been established either in the main markets or in potential markets. Some of the reasons for this can be found in the absence of trade promotion incentives, others in the absence of a tradition of involving private agents in foreign trade policy-making.

ii) *Quality control policy*. As an export-promotion mechanism, this policy is a new and increasingly important issue in the region, since quality is becoming a key dimension of competitiveness in international markets.

Including this policy among the various incentives for improving exportable supply can help enhance productivity and facilitate the adaptation of supply to stricter standards of international demand (see box V.3).

Such adaptation is something of a priority as regards environmental and phytosanitary standards, particularly for access to the EEC market, which demands official certification in the case of horticultural and fruit products exported to that region.

From a more global standpoint, encouraging the introduction of quality control systems in enterprises permits the modernization of management techniques and, particularly in small and medium-sized enterprises, the rationalization of costs and the improved utilization of available incentives, which often go unused because of ignorance or poor business management. Stimulating the creation of private firms specializing in quality certification also encourages competition in the sector and motivates the public sector to concentrate on regulation and supervision. This same competition also gives the public sector more options when it must authorize testing laboratories.

3. Export processing regimes

Some Latin American and Caribbean countries have practised differential treatment of export processing units on a large scale as a way of stimulating their external sales, and also of promoting labour absorption and the spread of new technologies. Any analysis of this policy instrument should take into account the incentives granted to these units in comparison with the benefits to other producers/exporters, a topic that goes beyond the limits of this chapter. The purpose here is to discuss some of the indications of how important the maquiladora industry has become in the region, and to draw some conclusions based on specific country experiences.

a) Export processing zones

Export processing zones (EPZs) are physical and economic enclaves where free-trade and export-promotion policies can be applied without modifying the trade regime or the structure of protection throughout the rest of the country.[56] These zones are limited areas outside the jurisdiction of the country's customs authority. Although most of the firms operating in these zones tend to be subsidiaries of transnational corporations, there are also large numbers of joint ventures and national firms subcontracted by companies operating in importing countries. Generally speaking, EPZs produce labour-intensive goods such as light manufactures (garments, electronic products, processed foods and others) whose transport costs are low.

There are more than 200 EPZs or "free zones" in the developing economies, the first of which were set up in South-East Asia. Their creation is not linked to the size

56 The defining of EPZs as physical enclaves is not always accurate. In a number of countries, certain plants —which are located in various parts of the country— enjoy differential fiscal and exchange-rate treatment in order to produce exportable products.

Box V.3

CHILE: EXPORT QUALITY

The Government has presented to the legislature a bill on the establishment of a national quality control system to promote the standardization of export products and the creation of mechanisms for certifying them. The idea is to move towards a system of export quality certification that is flexible enough not to obstruct exports but provides the incentives needed to effectively bring about improvements in the quality of exported products.

This idea has taken shape in a National Quality Programme that initially functioned in the areas of technical standardization, sectoral authorities, metrology and quality certification. In this last area, the proposal is to establish a National Quality System in which sectoral quality authorities would participate and would be responsible for authorizing the certifying agencies of the corresponding ministries, and a technical service agency in charge of standardization, metrology and the monitoring of authorized agencies. The system would be coordinated by a National Quality Secretariat, which in turn would be the executive arm of a National Quality Council, composed of representatives of the public and private sectors.

Preliminary studies have uncovered a broad set of functions relating to quality, safety and health dispersed among various ministries, a relative obsolescence of technical standards and an overlapping of regulations, often with others that have not been formally repealed or whose legal status is unclear.

CORFO (Production Development Corporation) recently created a technical assistance fund for quality control and technology transfer, to support such functions in small and medium-sized enterprises. The fund operates in five modules: diagnostic analysis, training in the concept of quality, planning, administration and production processes in quality systems and product design. In each of these modules, the firm can receive a subsidy equivalent to 75% of the cost of the consultants it hires, up to a limit of nearly US$ 2,000. The modules are cumulative in order to encourage the establishment of integrated quality systems in enterprises. The programme was initially funded with US$ 232,000.

A national quality prize has been established and is awarded in October, designated "quality month", to outstanding firms in this area.

At the sectoral level, the difficulties faced by Chilean fruit in entering the EEC market in 1993 prompted an active national debate on quality control for fruit exports. This led to a plan for regulating fruit growing, drawn up by the Association of Exporters, the Federation of Fruit Growers and the National Agricultural Society. The plan envisages a system of compulsory quality certification based on certain standards; verification of the condition of the fruit upon arrival at its destination; and a system for the programming of shipments that avoids situations of oversupply and organizes the timing of the fruit's arrival in the main export markets.

Source: Science, Technology and Quality Programme of the Ministry of Economic Affairs, Development and Reconstruction of Chile.

of the domestic market, but to the supply of relatively cheap labour, the availability of services and infrastructure, and the absence of trade or exchange barriers and administrative hurdles. For example, in Latin America and the Caribbean, there are free zones in Costa Rica, Colombia, Dominican Republic, El Salvador, Guatemala, Grenada, Haiti, Honduras, Jamaica, Mexico, Saint Lucia and other countries. Table V.6 shows the relative weight of EPZs in the total exports of some countries of the region.

The most common incentive for these zones is the tax exemption on imports of foreign merchandise, both consumer goods and industrial goods for use in the zone itself. Nearly all free zones also offer exemption from indirect taxes on these operations, income tax exemption and, in some cases, permission to sell a limited percentage of production on the domestic

Table V.6

IMPACT OF MAQUILADORAS/EXPORT PROCESSING ZONES ON TRADE: SELECTED COUNTRIES, 1980-1992

	1980	1985	1990	1992
Mexico[a]				
Total exports (A)	15.5	26.8	40.7	46.2
Maquiladora-EPZ exports (B)	2.5	5.1	14.1	18.9
Exports of manufactures (C)[b]	3.0	5.0	13.9	16.7
B/A (%)	16.1	19.0	34.6	40.9
B/(B+C)[c] (%)	45.5	50.5	50.4	53.1
Jamaica[d]				
Total exports (A)	963	610	1 323	1 275
Maquiladora-EPZ exports (B)	-	70	289	384
B/A (%)	-	11.5	21.8	30.1
Dominican Republic[d]				
Total exports (A)	1 079	954	1 574	1 757
Maquiladora-EPZ exports (B)	117	215	839	1 191
B/A (%)	10.8	22.5	53.3	67.8
Saint Lucia[d]				
Total exports (A)	46	83[e]	127	-
Maquiladora-EPZ exports (B)	-	7.5[e]	19.1	-
B/A (%)	-	9.0[e]	15.0	-
Costa Rica[d]				
Total exports (A)	1 003	1 090	1 668	2 171
Maquiladora-EPZ exports (B)	4	149	307	453
B/A (%)	0.4	13.7	18.4	20.9

Source: Banco de México, *México: Indicadores económicos*, Mexico City, various issues, and *The Mexican Economy-1993*, Mexico City; L. Willmore, "Export processing in Jamaica: ownership, linkages and transfer of technology" (WP/93/13), Port of Spain, ECLAC subregional headquarters for the Caribbean, 9 September 1993; and "Export processing in the Dominican Republic: ownership, linkages and transfer of technology" (WP/93/15), Port of Spain, ECLAC subregional headquarters for the Caribbean, 14 September 1993; Economic Commission for Latin America and the Caribbean/External Trade Data Bank for Latin America and the Caribbean (ECLAC/BADECEL); International Monetary Fund (IMF), *International Financial Statistics*, various issues.

[a] Billions of dollars. Total includes gross value exported by maquiladoras. [b] Excluding manufactures produced in maquiladora plants. [c] Estimated relative weight of maquiladoras in total exports of manufactures. [d] Millions of dollars. [e] 1986.

market if the corresponding import taxes are paid. EPZs are also special because they offer freedom of exchange, in the sense that foreign exchange obtained from exports is openly available. In general, these incentives are granted for a limited though fairly long time, usually about 20 years.

The most successful free zones are those whose operations are highly efficient. In addition to the need for quality infrastructure and communications, the main promotion policies depend less on generous tax and financial incentives than on the simplifying and minimizing of red tape, including port and customs formalities.

An important aspect of the attractiveness of EPZs is their capacity to consolidate trade and administrative transactions into a single service (one "window"), which centralizes all formalities, intercedes with other government offices, takes decisions and solves administrative problems. This simplification of transactions and decision-making allows the investor to spend less time on procedural matters, thereby reducing his administrative costs and improving the competitive environment.

It is true that EPZs may have both benefits and costs. Where the developing countries have encouraged the creation of EPZs, they have done so to promote the

net inflow of foreign exchange, increase productive employment and attract foreign direct investment and technology; to open up opportunities for training the workforce and improving management skills; and to further the establishment of linkages between the firms located in the free zones which are closer to international competition and more sensitive to technological innovations and domestic firms.

The benefits of EPZs should be assessed in the light of their potentially changeable nature. One possible scenario is that free zones might generate growing levels of value added and foreign exchange, requiring more and more skilled labour and using constantly updated management techniques based on the best international practices. Alternatively, these zones may stagnate or diminish in importance to the extent that the countries where they are located become less attractive than other countries because their workforce is less competitive, their infrastructure is inadequate or they are politically unstable. It may be useful to specify the circumstances that encourage the development of EPZs, including the possibility of a transition towards the formation of an "export processing country or territory", as has occurred in Singapore and Hong Kong.

Various aspects of these zones need to be taken into account. The net volume of exports is considerably lower than the gross volume, owing to the large content of imported inputs used in EPZ industries. The infrastructure required for the installation and operation of free zones entails direct expenditure that may considerably raise the cost of the employment created. In addition, there are implicit subsidies in the value of the land, industrial sites, public services and other services provided to firms.[57] Finally, the concessions and incentives granted to the firms located in EPZs have in some cases crowded out local producers whose facilities were originally located outside the special zone.

The creation of EPZs may be an initial stage in the process of export-oriented industrialization in developing countries or in given regions of these countries. In fact, special zones are often found in remote areas where fewer alternative opportunities exist for absorption of labour.[58]

Productive development in EPZs may remain confined to assembly operations, with two possible consequences. First, the absence of linkages limits the impact of exports on the income and productivity of the rest of the economy, although the importance of this factor depends on the production base, competitiveness and policies for encouraging or discouraging linkages in the country in question. Second, the absence of systemic competitiveness—particularly the dependency on cheap labour and preferential access to world markets— raises the possibility of disinvestment or of the sudden interruption of new investments in these zones.[59]

Note that, in order to promote linkages between firms located within EPZs and domestic firms, the economy should have effective finance mechanisms, technological support and human resources training, so that it can take advantage of the incentives provided by EPZ activities.

b) Export processing in the Caribbean

i) *Employment effects and labour markets.* Along with the tourist industry, export processing plants have been important generators of employment in several countries of the Caribbean. Employment

57 Note that private EPZs also exist, for example in Costa Rica and the Dominican Republic, which do not receive subsidies.

58 The absence of adequate infrastructure may prevent the development of these EPZs; hence it is more useful to limit the number of objectives in order to increase the probability of meeting them.

59 This is a danger, as repeatedly pointed out in the Caribbean and Central America, which might result from the signing of the North American Free Trade Agreement; it would involve an erosion of preferential access to the United States market on the part of the beneficiaries of the Caribbean Basin Initiative.

in the export processing plants of the Dominican Republic's free zones increased from 20,000 workers (23% of manufacturing employment) in 1981 to 141,000 workers (or 63% of manufacturing employment) in 1992. Free zones accounted for 1.3% of all jobs in 1980 and 6.6% in 1991. In Saint Lucia, the largest of the seven members of the Organization of Eastern Caribbean States (OECS), it is estimated that export processing firms employ more than 2,800 persons in 17 plants, representing half the jobs in manufacturing and 6% of all jobs in the economy. Finally, the Jamaican economy employs more than 900,000 persons, of whom 31,000 (mainly young women) work in export processing plants. Export processing accounts for 3% of all jobs in the economy, and 30% of manufacturing employment.

Wages, benefits and working conditions tend to be better in the free zones than in the rest of the country. Employers in the free zones are subject to the same labour laws as employers elsewhere. In the Caribbean countries labour unions are legally free to operate, but there is little union activity in any of the free zones. In the Dominican Republic a minimum level of fringe benefits is required by law, basically social security, paid holidays and vacation days, as well as a Christmas bonus of one month's pay. Most Caribbean free zone companies provide benefits in excess of the minimum, as well as numerous bonuses for punctuality and productivity. In Saint Lucia, incentive pay in some cases is greater than the regular payroll. In Jamaica, fringe benefits are more generous in the garment and assembly plants than in the data processing or telemarketing companies; approximately half of the local expenditure is on wages; the remainder is for utilities, local transport, rent, imports from the Jamaican customs territory and the like.

ii) *Linkages and the transfer of technology.* Offshore assembly is universally valued as a means to employ large numbers of relatively unskilled workers, but its value as a vehicle for the transfer of technology is frequently overlooked. Nevertheless, the importance to an economy of introducing workers for the first time to the rigours of an industrial environment, and to the ideas of punctuality, quality control and deadlines, should not be minimized. Furthermore, different policies may represent incentives or obstacles to the transfer of technology, as demonstrated by the experience of the Dominican Republic and Jamaica, in comparison to that of Saint Lucia.

In the Dominican Republic, export processing and tourism have been the only dynamic sectors of the economy in the past decade. In the 1982-1991 period, GDP grew by an average of only 1.2% a year, exports of goods from the customs territory fell in both volume and value, and manufacturing production outside the free zones decreased. Over this same period, expenditure by tourists grew at an average rate of 14% a year, to US$ 877 million, exports from the free zones grew by 23% a year, to more than US$ 1 billion, and foreign exchange earnings of the free zones increased by an average of 17% a year, to US$ 249 million.

The range of products produced in the free zones in the Dominican Republic has increased markedly over the years, yet concentration of output in the textile industry has actually risen slightly, with the result that the manufacture of textile products now occupies more than two thirds of the companies and employees who work in the free zones. Assembly of electronic and electrical equipment has grown rapidly, though it still accounts for less than 5% of free zone employment. Another new export is data processing, an export service in fields such as airline reservations and the compilation of health insurance claims for foreign clients (see box V.4).

Free zone exports from Jamaica grew rapidly until 1989, but have since stagnated. Similarly, the local expenditure of free zone companies increased steadily until 1989, when they began to decline. The United States is the main source of investment and the main market for export processing firms in the free zones of these Caribbean countries.

Box V.4

DATA PROCESSING: A NEW TYPE OF MAQUILA IN SELECTED CARIBBEAN COUNTRIES

The island of **Grenada** in 1989 successfully attracted a United States-owned company that employs 150 data entry operators and has another 30 people in training. One reason for this success is that the investors installed a satellite dish in Grenada, enabling them to send and receive images of documents on their own equipment rather than having to ship them or pay high fees to the local telephone company. Last year, the parent company acquired a corporation (previously owned by the local telephone company) in Dominica. the number of jobs grew from 85 to 115, and a satellite dish was installed. Poor communications restrict **Saint Lucia** to the processing of articles for medical or legal journals and the like, which do not require fast turn-around times, while companies in Grenada and Dominica are able to service customers such as Federal Express, Bank of America, Xerox and Blue Cross of California.

Ten years ago only five data processing firms existed in all of **Jamaica**, and they serviced, for the most part, the domestic market. The industry grew rapidly when the Government offered incentives to firms that were willing to specialize in export markets, with no domestic clients. These exporters of services now employ more than 2,500 workers. In 1985 the Government changed this policy, ruling that for data entry services, unlike manufactures, tax exemptions and duty-free import privileges would be restricted to companies located in the free zones.

Jamaica's shortage of skilled labour affects the data processing industry, which prefers to hire high school graduates with typing abilities. Owners and managers of firms in the industry complain that they have difficulty recruiting data entry operators, and those that they do recruit have such poor general skills that they require a minimum of three to four months of training. During the training period, though their productivity is close to zero, they must be paid the legal minimum wage. Once trained, the operator often moves to another employer, as there is fierce competition for the limited pool of trained data entry operators, given a competition policy in the labour market of data processing firms rather than a cooperation policy as garment manufactures. This is a classic case of externalities: the company that incurs the expense of training a worker is not able to recoup its investment, hence all firms invest too little in training new workers. Basic training could better be done outside the firm, with all firms in the industry sharing the costs. In addition, more of the cost would be borne by the trainee, as he or she need not be paid a minimum wage for the duration of the training. The data processing firms in the Kingston area have, in fact, begun a programme of this type for high school graduates in cooperation with a government vocational programme called Human Employment and Resources Training.

The data processing industry in Jamaica provides interesting growth prospects because it is supply-constrained rather than demand-constrained. Managers of firms in the industry allege that they could employ many more operators were they available. Their requirements are functional literacy and good typing skills; trainees who start with a basic commercial education can easily learn to manipulate the programmes for data entry and word processing. This is a highly competitive industry, however, in which Jamaicans must compete with firms throughout the world, so wages are low despite the severe shortage of personnel.

Data processing firms must remain abreast of technological advances in both software and hardware if they are to remain competitive. This they appear to be doing successfully in Jamaica. Many of the companies are now incorporating image scanners in their operations, for these devices remarkably increase productivity for some types of data entry.

Source: L. Willmore, "Export processing in Jamaica: ownership, linkages and transfer of technology" (WP/93/13), Port of Spain, ECLAC subregional headquarters for the Caribbean, 9 September 1993; and "Export processing in the Dominican Republic: ownership, linkages and transfer of technology" (WP/93/15), Port of Spain, ECLAC subregional headquarters for the Caribbean, 14 September 1993.

Seventy of the 79 locally owned companies in the Dominican Republic are in the textile and garment industry, and most of the remainder are in the "low-tech" industries of footwear and leather articles, ceramics and furniture. In the case of apparel and footwear, local companies are subcontractors that assemble products for overseas firms.

Dominican free zone enterprises have competent management, use the best conventional production practices and may satisfy exigent requirements of quality and delivery. Quality and manpower qualification levels are high. In contrast, technically backward producers for the domestic market have not benefited from the presence of exporters in the free zones, given the weak linkages between the two kind of producers. Firms producing for the domestic market operate at low levels of efficiency and use old-fashioned quality control systems.

Backward linkages are almost nonexistent between free zones and the customs territory of the Dominican Republic. Bureaucratic requirements such as export licenses impede sales from the customs territory to free zone companies. Although there is legislation dating from 1979 that provides for the temporary import of goods that are incorporated into exports (Act No. 69 on Export Incentives), in practice this has never functioned as it was intended. Nor is there any drawback mechanism that allows an exporter to recover duty paid on imported raw materials and intermediate inputs, quite apart from the costs that stem from delays in clearance by customs authorities. This makes products of the customs territory uncompetitive in open markets, including the free zone markets. High costs, combined with great difficulty in meeting quality standards and delivery deadlines, are a singular barrier to these linkages (see box V.5).

In Jamaica, free zone companies are almost never allowed to sell their goods in the domestic market. Firms operating outside the free zones under the Export Industry Encouragement Act regime face severe obstacles if they attempt to produce for the local or subregional market, so all of them have opted to export the whole of their output to markets outside the Caribbean Community (CARICOM). The only way they can legally supply the local market is by maintaining a physical separation in the factory between goods processed for export and goods processed for the local and CARICOM markets. The small size of the local market makes this unattractive.

The result of the regulatory environment is thus a segmented garment industry in Jamaica. One segment is modern, large-scale, efficient, highly productive and produces solely for the export market. The other segment is small-scale and largely unspecialized; its productivity is low and it produces for the domestic and, to a very limited extent, CARICOM markets. There is virtually no contact between the two segments; neither workers nor managers move from one segment to the other.

For Saint Lucia, however, export processing may represent a useful first step in the path of industrialization. Much of the work of export processing companies in Saint Lucia cannot be described as mere assembly. In the garment industry, nearly three fourths of the employees are in factories engaged in the cutting, making and trimming of garments rather than sewing of pre-cut garments. The largest electronics firm on the island produces wirewound resistors to exacting specifications using sophisticated equipment; it then coats and labels them. Another company uses plastic injection machines to produce from PVC pellets and its own waste plastic a variety of novelty items, including souvenir coasters and key chains for Euro-Disney. Considerable transfer of technology also takes place in export processing companies at the managerial and supervisory levels, where all supervisors and most of the managers of export processing plants are citizens of Saint Lucia.

Saint Lucia's export processing companies have been able to develop backward linkages for several reasons: i) local businesses can sell goods and services to enclave and free zone factories without

Box V.5

GARMENTS: TRADITIONAL EXPORT PROCESSING

In **Saint Lucia** the manufacture of clothing now accounts for 72% of total employment in export processing companies, up from 65% in 1989. This industry also accounts for more than 80% of all imports and exports of goods by export processing plants in the period 1986-1990.

Because of its small size, Saint Lucia does not face binding quotas in the United States, its main export market. Perhaps for this reason, six of the nine factories and three quarters of the workers cut, sew and trim imported Asian cloth rather than assemble cut textiles imported from the United States under the customs item 807 scheme, even though the former face full customs duties in the United States.

The garment industry also accounts for the bulk of export processing in Jamaica: 74 of the 109 firms and nearly 90% of employment. Data processing is the next largest export activity, but the firms are small compared to manufacturing plants.

Employment in **Jamaica's** garment industry increased from approximately 6,000 persons in 1983 to 28,000 today, an average rate of growth of 19% per annum between 1983 and 1992, but this rate was much faster through the end of 1987 than in later years. All the growth in employment stems from companies dedicated exclusively to exports to non-CARICOM countries. These exports increased steadily from US$ 11 million in 1983 to US$ 384 million in 1992, with the most rapid increase occurring in the early years, 1983 to 1987. More than half the exports are garments sewn of United States-cut cloth to take advantage of United States customs item 807 (renamed HS 9802.00.80) and pay duty only on the value added in Jamaica. Less than half the value of exports is of the "cut, make and trim" variety which creates more employment in Jamaica per dollar of exports even though the cloth, in any event, is always imported.

Increasingly, the cloth utilized in offshore assembly under the 807 scheme is both manufactured and cut in the United States so as to qualify for the Caribbean Basin Initiative Special Access Program (807A/9802A), by which the United States has granted generous quotas to Jamaica. In 1992, Jamaica was the largest supplier of "807" hosiery and underwear to the United States market.

Although the **Dominican Republic** has been a beneficiary of the European Economic Community's Lomé Convention since 1989, the United States and its possessions continue to receive nearly 95% of the exports from the free zones. As a major supplier of textile products to the United States, the Dominican Republic is understandably concerned about the effect that the formation of a free trade area under the North American Free Trade Agreement (NAFTA) might have on these exports, since clothing, along with most textiles, leather products, footwear and gloves, are specifically excluded from the Caribbean Basin Economic Recovery Act.

Source: L. Willmore, "Export processing in Jamaica: ownership, linkages and transfer of technology" (WP/93/13), Port of Spain, ECLAC subregional headquarters for the Caribbean, 9 September 1993; and "Export processing in the Dominican Republic: ownership, linkages and transfer of technology" (WP/93/15), Port of Spain, ECLAC subregional headquarters for the Caribbean, 14 September 1993.

first obtaining an export license; ii) backward linkages from the banana industry (to plastic bags and paperboard cartons) mean that intermediate goods are produced on a large enough scale that costs are not excessive; iii) producers of intermediate goods pay no tax other than a 3% customs service charge on the raw materials they import, and sales to exporters are automatically exempt from the consumption tax that is charged on goods destined for the local market. In sum, policies in Saint Lucia are conducive to the formation of backward linkages, in contrast to policies in effect in Jamaica or the Dominican Republic.

c) *The maquiladora industry in Mexico*

i) *Employment and foreign exchange.* Mexican maquiladoras have been in operation since 1965.[60] Imported materials and components enter the country duty-free and are mainly exported to neighbouring countries after having been semi-processed or assembled in a registered plant. These firms are licensed to sell up to 20% of their production on the domestic market, and the import tax on foreign components and inputs is applied to these sales.

In the second half of the 1980s and in the early 1990s, there was a boom in the maquiladora industry in Mexico. Between 1980 and 1993 the number of plants rose from 620 to 2,142 in 29 of the 32 federal states of Mexico; the number of jobs increased from 124,000 to 532,000; and the value added (net exports) increased from US$ 772 million to US$ 5.9 billion. Since the end of the 1980s, the maquiladora industry has become the second most important generator of foreign exchange and the most dynamic source of jobs in Mexico, representing about 17% of the new jobs created in the manufacturing sector (SECOFI, 1992a).

At the beginning of the 1990s, slightly over 50% of the maquiladora plants set up in Mexico belonged either entirely or in large part to United States investors; about 40% were totally or primarily Mexican-owned; and the rest were controlled by Japanese, German or Spanish investors. Data for 1992 show that the principal productive activities of the maquiladora industry in terms of local value added were the following: transport equipment (28%), electric and electronic materials and accessories (25%), electric and electronic machinery and appliances (11%), other manufactures (10%) and textiles (7%). Of the total number of maquiladoras, 90% are located in states bordering the United States, with only 10% being in the interior of the country (see table V.7).

ii) *Linkages and transfer of technology.* The maquiladoras have not significantly increased their use of Mexican-produced materials, parts and components; only 4% of the inputs used since the programme was launched in 1965 are of domestic origin. The main reasons for this negligible integration with other industries located in Mexico are as follows: the concentration of potential domestic suppliers in areas far from the northern border (for example, in the Mexico City metropolitan area); an inadequate communications infrastructure (until recently) between the border and the interior; and still unsolved problems of price, quality and delivery dates on the part of domestic vendors. In addition, the isolation of the maquiladoras from the rest of Mexican industry may be due precisely to government policies applied during the long period when the maquila was regarded as an inferior activity (see box V.6 and Grunwald, 1989).

Although maquiladoras have some of the same features as enclaves, they have had a highly positive effect on labour skills at different levels: workers, supervisors, technicians and administrative personnel.[61] The very reason that maquiladoras were set up in the first place (labour cost savings) generally precludes those firms from using foreign staff and manual workers. With the exception of top management positions, and sometimes even without this exception, the staff of the maquiladoras are Mexican.

With regard to technology transfer, the situation in the maquiladora industry is determined by the very nature of the

60 Note that the term "maquiladoras" in Mexico is applied to firms which are subject to a given legal regime. Although in some cases it is also used to refer to assembly operations with a low local content of parts and components, not all activities of this type may be considered maquiladoras from the normative standpoint.

61 It is often said that the workers in maquiladoras carry out low-skill tasks from the technical standpoint, which may be true if these are compared to the work being done in maquiladoras and similar industries in the United States; however, workers in Mexican maquiladoras require no less technical training than those in other Mexican industries (Sklair, 1989).

Box V.6

THE MEXICAN MAQUILA AND INTEGRATION WITH OTHER DOMESTIC INDUSTRIES

A detailed analysis of the cost structure of the Mexican maquiladora industry shows that the percentage of local value added and of physical and service components of domestic origin is much higher in plants located in the interior of the country than in those on the border (see table V.7). Although it represents only a small percentage of the maquiladora industry (0.3% of the total), the part operating in Mexico's most industrialized zone (the Federal District and the state of Mexico) shows higher percentages of domestic integration. Precisely because the northern part of Mexico is close to the United States, and therefore a very attractive area for installing maquiladoras, it is anti-economical to integrate the activity of these plants into an industrial structure concentrated in the centre of the country. The shift of this structure towards the north, as has occurred in a number of industries, could somewhat reduce the problems facing the maquiladora industry in improving its integration with domestic production, but it is not likely to eliminate them.

Source: W. Peres, "From Globalization to Regionalization: The Mexican Case", Technical Papers series, No. 24, Paris, OECD Development Centre, 1990.

Table V.7
STRUCTURE OF THE VALUE OF PRODUCTION IN THE MEXICAN MAQUILADORA INDUSTRY[a] (1993)
(Percentages)

	National total	Border states[b]	Interior	State of Mexico and Federal District
Wages and benefits	13.4	12.8	16.2	23.5
Domestic raw materials and packing containers	1.4	0.7	3.9	14.5
Miscellaneous expenses in Mexico[c]	6.2	5.0	11.0	17.5
Profits, etc.	3.1	2.5	5.6	7.5
Subtotal (value added in Mexico)	24.1	21.1	36.7	63.1
Imported raw materials and packing containers	75.9	78.9	63.3	36.9
Gross value of production (GVP)	100.0	100.0	100.0	100.0
Regional structure of GVP	100.0	80.7	19.3	0.3

Source: INEGI (National Institute of Statistics, Geography and Informatics), *Avance de información económica: industria maquiladora de exportación*, Mexico City, May 1993.

[a] These figures cover the period up to April 1993. [b] Northern Baja California, Coahuila, Chihuahua, Sonora and Tamaulipas. [c] Including rental of machinery, equipment, buildings and sites, electric power, telephone, telegraph and telex; customs formalities, freight and transport; maintenance of buildings and equipment; and other expenses.

activity, which is export-oriented. Available data show that maquiladoras are no longer devoted to unskilled-labour assembly activities as in the late 1960s and early 1970s, and have become relatively skilled-labour-intensive manufacturing and assembly industries. This shift is due to the new sectoral composition of the industry, which has moved from being basically an apparel industry into being an activity concentrated on producing electronic products, electrical equipment and components and automobile parts.

There is also evidence of widespread use of modern managerial techniques in the maquiladoras in the new industrial sectors (Carrillo, 1989). Just-in-time inventories, statistical process control, zero-defect techniques and work teams are now common practices; these have led to more labour training and efforts to reduce the high turnover rates prevalent in this activity (8%-15% a month).

To sum up, subcontracting arrangements have both advantages and disadvantages for developing countries. Those which have not been able to go beyond the EPZ stage suffer from all the well- documented problems of low wages, long workdays, high staff turnover and job insecurity. On the other hand, subcontracting has been a decisive element in the rise of the newly industrializing Asian economies in the production hierarchy and in their becoming successful industrial exporters. The difference is due to many factors, which are discussed in another section of this study. In short, they include investment in human capital, technological innovation and government support to help firms improve their performance.

Chapter VI

TOWARDS AN INTEGRATED TRADE REFORM

Import liberalization or rationalization is only one of the ingredients of an integrated trade reform. As noted in earlier chapters, most of the countries of the region have carried out extensive tariff reforms. The trade dimension, however, includes many other policies apart from tariffs. It also covers export promotion instruments such as exemptions and drawbacks. The changes in international trade rules are having a great impact on the leeway available to the Latin American and Caribbean countries in designing their export promotion policies. Past policies tended to focus on manufactures exports, often neglecting products based on natural resources, and therefore wasting production potential. An integrated approach should consider the whole production system, and take into consideration that in most of the region, natural resources will long continue to represent the base for most exports; there is ample opportunity to develop comparative advantages in non-traditional exports based on natural resources.

1. Some general trade policy rules

One essential rule for trade policy is that it should be highly selective. The main problem with import substitution policies was not their selectivity but that they ended up being generalized, and hence lacked clarity and transparency about what was being promoted or what purpose was being served by intervention (except perhaps that of benefiting the business groups which had the most influence on the authorities). The severe budgetary constraints on the State in matters of information and management should also be recognized. This means that public action must focus on a few strategic, carefully selected areas.

Since most industrial activities are subject to more or less diffuse dynamic externalities, it could be argued that it is desirable (Rodrik, 1992) to encourage broad categories of manufacturing activities, rather than choosing "winners". It is also true, under the premise that competitiveness can be acquired, that a flat tariff no longer makes sense. Some graduation of tariffs (as in other political instruments) has become desirable. In fact, as noted above, most of the countries of the region have chosen a non-uniform tariff. The degree of differentiation —which is now considerably smaller— and the average level of the tariff will depend on a series of factors, including stage of economic development, the possibility of smuggling and absolute size of the economy. Notwithstanding, for reasons of administrative efficiency and transparency and to avoid corruption and non-productive activities, it is useful to limit the number of tariff brackets.

Two more general but essential considerations are in order. First, the highest tariffs (or incentives for specific activities) should be strictly temporary, with a pre-

announced schedule for tariff-cutting (or reduction of subsidies). Second, the tariff schedule should be similar to that of export incentives, so as to avoid the anti-export bias induced by the tariff.

On the assumption that it is more useful to promote certain categories of economic activities than to focus on specific items, "automatic graduation" could be applied to a considerable number of sectors and then suspended once a given target has been reached. Automatic graduation has an appreciable advantage in terms of taking into account the weaknesses of Latin American States and how difficult it is for them to discourage entrepreneurs from seeking easy profits. In addition, if such a mechanism were applied to a range of activities rather than to specific products, the market would have ample room to choose the activities to be promoted.

A particularly fruitful area for applying selective policies is that of "self-destructive" incentives for non-traditional exports, i.e., incentives that automatically cease to apply once the target has been reached.

2. Export-promotion policies

Although the anti-export bias has been largely corrected in the region as a result of trade reforms, it continues to exist, to a greater or lesser extent, in all the economies of the region. This is why it is important to promote exports, particularly those that are knowledge-intensive or have a high value added. If they are not promoted, their volume, together with the number of exporting firms and products, will be less than desirable, and might tend to be concentrated in only a few firms and in products for which demand is less dynamic and more vulnerable in world markets.

In such case, the level and quality of exports will be sub-optimal because of the intense externalities that are characteristic of this activity. Firms that begin to sell new categories of exports generate more benefits than they can assimilate —for example, knowledge and prestige— and this creates externalities that accrue to other firms and the economy as a whole, when exporting becomes an established activity and the standing of the country's new export products is consolidated. These externalities justify government support for pioneer export firms.

The shortcomings of capital markets are another good reason for promoting exports. If the banks in the region are reluctant to provide long-term and risk capital for investments in their own countries, for example, their reticence is even greater when it comes to export credits. If the government does not act, financial support for exports will be sub-optimal.

The common argument about economies of scale, in a climate of economic globalization, is reinforced and complemented by other views. Exporting makes it easier for firms to gain know-how and makes them more competitive, allowing them to stay in close touch with changes in demand, receive signals and information on new products and keep abreast of the latest technological and organizational changes.

Export promotion in general should be based on a sustainable macroeconomic framework, a high, stable exchange rate and clear, permanent rules of economic functioning. The promotion of non-traditional exports, however, requires a certain degree of selectivity. Mechanisms to promote non-traditional exports must be designed to be moderate, with pre-announced time limits and provisions for periodic evaluation to correct their course and ensure that firms have full access to incentives. These measures should therefore be selected in coordination with private-sector bodies, ensuring close, systematic cooperation between government and the private sector in developing export promotion activities. Otherwise, there is a danger that these programmes will become detached from the main concerns of the business world and thus lose their impact.

In the sustained promotion of non-traditional exports, three priorities exist,

namely, gaining access to inputs at competitive prices, promoting new products and markets and obtaining institutional support.

a) Gaining access to inputs at competitive prices

A basic condition for promoting competitiveness in export firms is to ensure their access to inputs under competitive conditions. Successful export experiences in most of the countries indicate that this factor is of crucial importance. Firms that want to import inputs to produce exports should have access to these inputs automatically once they have fulfilled certain basic requirements. A number of countries of the region have mechanisms that allow for the temporary import of inputs to produce export goods. It has been observed that the operation of these measures is much smoother and has a greater impact on the level of exports when it is automatic than when it is discretionary. On the other hand, there is less impact on exports in countries where firms must submit new applications each time they want to import inputs and then wait for discretionary approval.

Mechanisms that provide for tariff exemption for the import of inputs to produce export goods are preferable to those that allow firms to obtain reimbursements, since they are simpler to administer and cost the firms less, the latter being a decisive factor in high-inflation economies.

The temporary import of inputs to produce export goods should be accompanied by customs staff training programmes and by information campaigns. In some countries, temporary import mechanisms have been inefficient because of the obstructiveness of customs officials or lack of information about how these mechanisms operate. Ways should also be sought for including indirect exporters (domestic producers of inputs for exporters) in the system.

b) Incentives for developing new export products and markets

The public sector usually cannot afford to run a far-reaching drawback programme. At times, Governments have even been forced to eliminate such programmes because of their high fiscal cost. One efficient response to this situation would be to provide an incentive only to new export products or to those aimed at penetrating new markets. An example would be the Chilean experience with the simplified drawback for non-traditional exports, covering products whose exports have not exceeded a certain value in a given period. This mechanism has three advantages: i) it encourages exports of new products; ii) it automatically ceases to exist once it has met its objectives, and thus entails a limited fiscal cost; and iii) it requires exporters to complete only one simple, rapid formality.

In all cases, export incentives should be easy to apply for; they should be moderate, i.e., tending to help place competitive or nearly competitive products on external markets; they should have specific time limits; and they should be required to produce definite returns in terms of new products, volumes or markets.

The new GATT agreement on subsidies allows the developing countries less breathing-space than was available to the newly industrializing economies (NIEs) of Asia. However, importing countries are less likely to impose countervailing duties if subsidies are moderate, expressly temporary (especially those that are automatically graduated) and used by countries in which the subsidized products have only a small world market share. The Latin American and Caribbean countries will have to examine this agreement carefully to determine how they can promote new activities for international markets.

c) Institutional support for export activities

Since coordinated efforts are more effective than individual ones, it is desirable to consolidate export-promotion bodies — i.e., those in charge of information on exports, export finance and insurance, participation in international expositions, development of exportable supply and other aspects— in a single institution. In a number of countries of the region, export-

promotion bodies are scattered; they were established at different times, under various legal forms, and are not always well-coordinated with each other.

An entity that provides integral support for non-traditional exports should have stable financing, a qualified professional staff and close ties with the private sector, all of which will enhance its impact on policy decisions affecting exports.

d) Other aspects

Besides the ones mentioned above, a number of other areas exist in which government action may decidedly help improve export performance.

i) *Information*. One of the first problems facing export firms is lack of information. Strong externalities exist in this area, and the help of the public sector is crucial. This is why it is so important to create or establish information centres covering a wide range of variables, such as tariff levels abroad, potential export markets, prices, product specifications, export contacts and forthcoming international trade fairs.

ii) *Export finance and insurance*. In a number of countries of the region, financial support for exports is virtually non-existent or is available to only a few firms. Without financial support for working capital and to provide credit to foreign customers, firms are at a competitive disadvantage with respect to other countries where firms receive such support. In fact, there is evidence that the competitiveness of the exports of some countries of the region is based in part on their firms' access to credit for foreign customers. Often, competitive firms even lose markets because they cannot offer credit to buyers.

In addition, firms should have full access to export insurance, both against commercial risks to their customers and against political risks in target markets. The cost of information, often one of the most expensive items in the total cost of export insurance, could be cut by using regional information networks.

iii) *Management training*. One of the areas that should be covered by an export-promotion entity is management training. The attitude of entrepreneurs towards exporting and their knowledge about potential business opportunities in foreign markets and about mechanisms for promoting non-traditional exports are crucial factors in their decision to invest in the production of exportables. Often, entrepreneurs have little interest in exporting because they are accustomed to producing for a protected domestic market or do not know much about the export business.

iv) *Promotion abroad*. Promotion of exportable supply in other countries is an area with strong externalities which a number of Governments in the region are addressing. In most countries, however, public-sector support is insufficient. This is due in some cases to a lack of financial resources. The bodies in charge of promotion abroad need to have adequate resources to fund the participation of firms in international trade fairs, and should make more effective use of trade advisors in diplomatic missions abroad. It is also important for export-promotion bodies to work in close cooperation with private-sector entities, such as exporters' associations and business groups, to strengthen their efforts and avoid duplications and isolated initiatives. In a number of countries a certain weakness exists in the organization of exporters' associations, as can be seen by the limited amount of technical and financial resources devoted to designing private marketing strategies from a regional (markets) and sectoral (products) point of view. This reduces the possibilities for better coordination between the public and private sectors in external promotion and marketing, quality control and standardization of rules. Incentives could probably be offered to encourage organization and coordination within the export business itself, which would enhance the technical linkages between exporters and Governments.

v) *Development of exportable supply*. More active support should be provided for the domestic development of exportable supply, in order to adapt it to the demands of external markets. Promotion

should not be limited to existing products, but should help modify the exportable supply in time to respond to international demand. Timely, up-to-date information about demand in export markets, in terms of quality, standardization, time limits and volumes, would make this task easier and could encourage new firms to enter the export business.

One way of gradually adapting exportable supply to the requirements of foreign markets, while at the same time promoting linkages between domestic firms and international customers, would be to select specific sectors in which the country has export potential and, in conjunction with the private sector, to endeavour to create an exportable supply, promoting contacts with marketing and importing firms in the target markets. Besides laying the groundwork for strategic export alliances between domestic and foreign firms, this would encourage a systematic improvement in quality and stimulate the development of new products, as a flexible response to commercial opportunities. The programme to develop exportable supply being carried out by the Banco Nacional de Comercio Exterior of Mexico (BANCOMEXT) is a good example of such an endeavour.

3. Prospecting and development of natural, mining and agricultural resources

It is usually assumed that exports based on natural resources represent static, well-defined comparative advantages. The reality is that there is room to acquire and strengthen dynamic comparative advantages also in this field. The systematization and reinforcement of national efforts to identify the quality and volume of natural resources (including climate and seasonality) could make a very profitable contribution to the development of new production sectors. In fact, a number of countries in the region have managed to diversify their exports considerably by taking advantage of non-traditional natural resources.

Exploration for new natural resources is closely associated with the major scientific advances of this century. Technological progress has not only helped renew these resources and reduce their share in the consumption of many industries; it has also cut the costs of exploring and evaluating the quality of the resources.

In the case of mining, dynamic exploration activity is linked to the depletion of already exploited deposits and the need to lower the costs of further exploitation. In the agricultural sector, new technologies have made it possible to inventory existing resources more accurately, and this has led to better resource management and more environmental protection. It has also made it easier to compile official land registers according to carrying capacity or cultivation and current use. These registers have helped determine patterns of land division and farm ownership structure for purposes of development and, in some cases, tax assessment.

Mining exploration methods have also changed, and today it is possible to cover vast areas and concentrate on specific sites without much physical contact, a task which was very difficult to carry out using direct methods that required movement of materials and field sampling and measurement. Explorers now work more in their offices than in the field. They focus on studying the geological features observable in satellite images and, with the help of computers, manipulate innumerable variables to make a more precise evaluation and determination of size. Technological progress has made more accurate, rapid information available at relatively low cost: a large volume of data can be processed, and it is possible to work with various alternative mining models.

All this has been made possible by the great technological leap represented by remote sensing, which has revolutionized the exploration of natural resource potentialities, and has become a mainstay of the geosciences.

The images are obtained from remote sensors located on space platforms and even on a spaceship. These sensors have revolutionized the study of soils, vegetation, fresh water resources, hydrographic basins, the dynamics of marine and land ecosystems and, in general, the state of all the elements of the natural environment. This information makes it easier to prospect for different natural resources; to prepare land inventories in which soil features are taken into account; to prepare land registers or up-to-date inventories that are very useful in assessing forestry resources, permanent or long-cycle plantations and livestock populations; to detect problems of deforestation and desertification; to plan for better use of soils; to observe the movement of tectonic plates and volcanic activity; to control plagues and pests; and to improve urban development planning.

In addition, satellites provide the mine explorer with large-scale photographs of magnetic bands, which help determine the geological and geophysical features of the land that are invisible to the naked eye. Likewise, geophysical techniques can be used to obtain information from areas that are covered by soils, vegetation or transported material, making it easier to select the sites that will be examined in closer detail.

Geochemistry, using very advanced analytical methods and equipment, facilitates the study of the occurrence and dispersion of land elements and has perfected techniques for identifying minerals by sampling and analysing the different means of dispersion, such as soils, sediments, rivers and rock.

These technological changes have been favoured by the development of computer technology, which enables scientists to process and analyse a large number of variables. Thus, for example, the available software makes it possible to obtain models of the future development of deposits; to specify the clearing radius of mines and simulate the mined area; to study the geological features and the quantity of metal in the ore; to project flows to the dressing plants; and to calculate the volume of barren material that must be moved in the exploitation and, on this basis, determine more precisely the costs of the operation and, in general, make the financial calculations. In addition, extensive agricultural properties can be surveyed, for the purpose of compiling registers of productive units and scheduling planting on the basis of the best agro-ecological options. This information is also very useful for tax administration, since it makes it easier to identify potential taxpayers, while allowing for the design of territorial tax collection alternatives.

These data are of considerable interest to economic decision makers in the various markets and have helped countries to acquire comparative advantages in non-traditional exports.

4. Promoting efficient import substitution

There has been an outstanding increase in the number of export firms in the countries of the region in recent years. These include many firms that formerly practised import substitution. In the export-promotion effort, it is equally important to encourage competition among firms within the country itself.[62]

Most manufacturing firms in the region are undergoing a process of change and are making efforts, to a greater or lesser extent, to become more competitive. However, many potentially competitive firms will disappear if programmes to support their efforts are not implemented.[63] These firms need help in

62 In a study conducted in a number of Latin American countries, most of the entrepreneurs who were interviewed said that their first priority was to become competitive in the domestic market, and then to try to export (Guerguil, Macario and Peres, 1993).

63 In the most serious cases, if there is competitive potential, reconversion programmes should be developed to enhance competitiveness (see chapter VIII, section 4).

improving their competitiveness, especially in the following areas: gaining access to skilled labour and long-term finance at reasonable costs; acquiring inputs at competitive prices and quality in international markets; designing products in line with market trends; organizing production processes; reforming their quality control systems; and ensuring distortion-free conditions in which to compete.

One of the constraints faced by firms in their efforts to restructure and export is financial in nature. To become more competitive, they must invest heavily in improving various aspects of the production process. However, they must make these efforts precisely at times when anti-inflationary policies have driven up interest rates considerably. The fact that trade liberalization processes and stabilization are being carried out simultaneously has caused interest rates to soar in a number of countries of the region. Access to credit at non-subsidized but internationally competitive interest rates is an important component of current efforts to restructure and enhance the competitiveness of firms. Without financial support for working capital and to provide credit to foreign customers, manufacturing firms find it difficult to compete with firms in other countries where such support is available.

It is also important to overcome the serious shortcomings of weak, segmented domestic capital markets. Measures that should be considered include promotion and development of a long-term capital market and creating lines of financing for the purchase and leasing of capital goods, especially for small and medium-sized enterprises.

5. Para-tariff measures and unfair competition

There exists a series of trade policy measures frequently applied in the industrial countries which, except for quantitative restrictions, have been little used in Latin America and the Caribbean. These para-tariff and non-tariff measures have been thoroughly debated in the Uruguay Round, and the countries of the region should examine them carefully. They consist of anti-dumping procedures; countervailing duties to correct the distortions produced by subsidies; and safeguard measures, including quantitative restrictions, to deal with unexpected increases in imports. Each of these types of measures fulfils a different function and is governed by different international rules.

Anti-dumping and countervailing duties seek to correct the distortionary effects of unfair competition. Anti-dumping procedures are used when the origin of a distortion is the action of a foreign firm which uses price discrimination to crowd domestic producers out of the market and, once it is in a monopolistic position, to raise prices, hurting the consumer. Countervailing duties are meant to counteract the distortionary effect of government export subsidies. The need to resort to these duties will probably lessen as the export subsidy agreement under GATT limits the frequency of these subsidies on the international scene. The safeguard clause included in the General Agreement grants the right of self-protection against imports in specific cases, for domestic reasons unrelated to unfair competition.

It should be noted that the industrial countries interpret these mechanisms very differently and allow themselves considerable latitude in applying them, often in breach of both the letter and the spirit of GATT arrangements, and with clearly protectionist motives. This is true, for example, of "voluntary export restraints" —the so-called "grey area measures".

When anti-dumping mechanisms are imposed by developed countries, the victims are often firms located in developing countries, even though these firms are not in a position to practice price discrimination to crowd out domestic producers in the importing countries.

Until now, anti-dumping measures have mainly been used by the industrial countries. The agreement contained in the Final Act introduces a more rigorous approach to making the price comparison on

which the existence of dumping is based, and to determining the extent of harm to national producers and how long the measures taken by the affected country will remain in effect. It also specifies that consumers of the good must be consulted before imposing anti-dumping duties. Lastly, the agreement introduces a *de minimis* clause to protect small exporters. From the standpoint of Latin American countries as users, the anti-dumping agreement allows them to protect themselves from unfair trade practices originating in the behaviour of firms; such practices tend to increase during economic slumps in the countries that supply their imports.

In this respect, much remains to be done in the region. Most of the countries lack regulations in this crucial field; in the countries that do have them, these regulations have many shortcomings as instruments of protection against unfair competition.

The Latin American and Caribbean economies, especially now that they have liberalized their imports, could face dumping problems that would seriously affect those firms which have much less economic power than the transnational corporations that usually supply imports to the region. A distinction must be drawn between the normal competition that takes place in any market economy and predatory price policies, which seek to eliminate competition. The optimal solution would be to include this topic under the heading of competition-promotion policies, which suffer from serious defects in most of the economies of the region. As a partial solution, anti-dumping mechanisms that could adjust to the evolution of international rules following the conclusion of the Uruguay Round might be established. The public officials who oversee these mechanisms should be endowed with a high level of technological competence, to ensure that their decisions show professional rigour and hence warrant more credibility and prestige. If these bodies have highly qualified officials who are committed to competition, the danger of encouraging domestic protectionist practices can be avoided.

The safeguard clause has been invoked on only a few occasions, because most of the developed countries regard it as very restrictive. Article XIX of GATT authorizes the contracting parties to withdraw tariff concessions which have been granted to the other parties when a sudden increase in the quantities of imports, for reasons unrelated to unfair trade practices, is causing serious injury to domestic producers. The increase in tariffs must be temporary and equally applicable to all the imports affected, regardless of their country of origin, and a country which takes this type of measure must be willing to compensate the exporting countries which are adversely affected. Modification of the safeguard clause and the elimination of grey area measures that may be used instead were intensely debated in the Uruguay Round. There is an urgent need to adopt regulations on this topic in Latin America and the Caribbean, especially in relation to regional integration.

The Final Act of GATT prohibits all voluntary export restraints and other grey area measures which industrial countries have used rather than resorting to the safeguard clause of the General Agreement. Each trading partner will be authorized to retain only one measure of this type until the end of 1999. Although the use of quantitative restrictions as a safeguard is still permitted, even in exceptional cases against individual countries, the agreement establishes a limit of four years for their application, which may be extended up to a maximum of eight years in exceptional cases, and 10 years for developing countries. Any measure imposed for a period of more than one year must be gradually liberalized during the period of application. Safeguards against exports from developing countries whose share in the market is less than 3% are prohibited, unless the share of all the developing countries exceeds 9%.

If the industrial countries, under the agreement on safeguards, change the restrictive practices they have applied until

now into temporary safeguard measures subject to international surveillance, the developing countries will reap a clear benefit which will compensate to some extent for having been forced to accept, *de jure*, the imposition of quantitative safeguards.

The safeguard clause under GATT must also be assessed from the point of view of the developing countries as importers. The safeguard clause, which is almost never invoked by the Latin American and Caribbean countries, is just one more protectionist mechanism; it is important to domestic producers when they must face a sudden increase in competition from imports.

The dismantling of non-tariff measures and sharp reductions in the level and dispersion of tariffs in most of the countries of the region has made domestic production very vulnerable to competition from imports. While it is true that greater competition will enhance efficiency, it is none the less true that the economies of the region are very sensitive to short-term external shocks, which makes the exchange rate very volatile. As a result of the recent liberalization of trade, the vulnerability of producers of tradables will become more visible. It is therefore essential that the above-mentioned regulatory mechanisms, which have been little used until now, be given a much more important place than before in the region's trade regimes.

6. Conclusions

Experiences in trade liberalization complemented by export-promotion policies suggest that the different characteristics and current situation of each economy at the time of liberalization should be taken into account in any analysis. Factors such as the initial level of the exchange rate, export performance, investment rate and macroeconomic situation will determine the ultimate effects of trade reform. An analysis of experiences outside Latin America, such as that of East Asia (see box VI.1), supports this observation.

Briefly, the basic lessons learned from these experiences are:

i) There is no universal recipe for liberalization; the results vary according to the structural features of each country. It is the current economic situation and the policy mix pursued that determine the outcome of the process and its evolution over time. In every case, however, setting aside the debate as to which methods of liberalization are best, the region's economies are seeking chiefly to improve their linkages with the international economy. In addition to the gains in efficiency, entrepreneurial spirit and macroeconomic discipline that such efforts yield, the point is how to take advantage of the progress made so that these liberalization processes become pro-export biased. Part of the answer obviously lies in exchange rate policy, but there must also be export stimuli which are reflected in the creation of incentives and institutions.

ii) Tariff reductions should be accompanied (if not preceded) by a compensatory variation in the real exchange rate, which should be maintained in the period that follows. Easing access to imports in association with an exchange rate appreciation (and the use of exchange rate policy to stabilize prices) will endanger the equilibrium of the balance of payments and productive development.

iii) The countries that liberalized imports during the 1980s were generally pressured by the international economic climate to depreciate their real exchange rates. This contributed to a more efficient adjustment in Costa Rica, Chile (in the second stage) and Mexico. However, under the conditions prevailing from the beginning of the 1990s, when international capital markets began to see the Latin American countries as investment-worthy, liberalization of the capital account led to huge exchange rate appreciations (see Calvo, Leiderman and Reinhart, 1993) at a time when trade reform made a depreciation essential. The challenge facing economic policy is to find

Box VI.1

TRADE REFORMS AND EXPORT PROMOTION IN THE DYNAMIC COUNTRIES OF ASIA

Despite their marked diversity, the Asian countries that export manufactures have certain characteristics in common. Their experiences offer useful, relevant lessons for Latin America and the Caribbean, the most important being the following:

1) They all provided a favourable climate for growth, with stable, export-oriented policies. They all had low inflation, a balanced fiscal situation and high levels of saving and investment.

2) In all cases, an effort was made not merely to export but to industrialize for export. Incentives were more intense and broader in scope in the early stages of export promotion and coincided with expansive cycles in world trade; as the countries' industrial structures became more complex, incentives tended to become more general. After 25 years of export growth, there began to be periods of liberalization and economic deregulation, and direct action by the State was limited.

3) Export promotion influenced the impact of subsidies and controls on economic efficiency by imposing the discipline of international competition. Even when support measures deviated from market prices, they tended to be granted for limited periods of time and were subject to meeting certain export targets.

4) Investment for expanding export production capacity benefited from public policies that lowered the relative costs of investment goods, and from considerable efficiency in channelling savings towards productive investment. Investments were subsidized both through preferential interest rates or the direct allocation of credit to specific sectors, and through direct subsidies.

5) Private entrepreneurs played a key role in modernizing production, but were always subject to severe competition or to government regulation.

6) Labour markets tended to be non-competitive, either because trade union activity was repressed or because unions were co-opted.

7) High priority was given to infrastructure, education and technology. In some cases, public investment emphasized the transport sector, in others, housing or industrial zones; in all cases, education was a priority.

8) In every case, a policy of preventing a major exchange rate appreciation or sharp real fluctuations was applied, in contrast with what happened in Latin America.

Source: P. Petri, "The NICs: pragmatic policymakers", *International Economic Insights*, Washington, D.C., Institute for International Economics, March-April 1993; O. Rosales, "Desempeño reciente de los NICs asiáticos: políticas e instrumentos de fomento competitivo", Santiago, Chile, ECLAC, 1994, unpublished; L.E. Westphal, "Industrial policy in an export-propelled economy: Lessons from South Korea's experience", *Journal of Economic Perspectives*, vol. 4, No. 3, 1990.

a way to carry on with trade liberalization, bringing about an exchange rate depreciation, in a situation of huge net capital inflows. This challenge entails regulating the inflows and increasing domestic saving, in order to keep the real exchange rate at a competitive level in line with its medium-term determining factors. Consistency must be promoted between aggregate expenditure and aggregate output, and incentives provided for increasing investment and the production of tradables.

iv) During the transition phase of trade reform processes, misleading short-term signals may be sent, such as a temporary increase in exports resulting from an initial recession, or in imports, which do not react immediately to liberalization. Experience has shown that imports, like exports, take some time to gather momentum in cases where there are no pre-existing trade channels, consumers are not yet aware of new products so as to change their preferences, and producers have still not managed to restructure their

production systems to adapt them to new inputs. Once marketers, consumers and producers adjust their behaviour, a prolonged, intense process of import growth begins, while the increase in exports is obviously slower, since it involves longer investment-diversion processes. It is obviously important to avoid excessive restructuring that favours importables, and to send out clear signals as to the advisability of expanding export capacity. Again, balanced management of the exchange rate, a gradual overall reduction of protection levels and the different export promotion mechanisms will all play a crucial role in this process.

v) The experiences studied suggest that opening up the economy to imports and devaluing the real exchange rate are not enough to achieve high export and output growth rates. Complementary measures, geared directly to these objectives, are clearly needed, as can be seen from vario.s examples. The Asian economies, for instance, used integrated mixes of instruments and were careful to proceed gradually (see box VI.1), while Chile, despite a successful export performance, took some time to achieve a vigorous growth of productive capacity and Bolivia experienced problems in increasing its exports.

vi) Experience has shown that gradual reform processes in which decisions are shared with private agents are less traumatic, since they make it possible to adjust to the new conditions at the micro-economic and sectoral levels. If trade liberalization is accompanied by coherent macroeconomic policy and credibility in government action, there are better chances of working together to reduce the costs of adjustment. Likewise, for liberalization to result in substantial increases in exports and output, import liberalization must be accompanied by explicit incentives to exporters, including the elimination of bureaucratic barriers to exports.

vii) Besides removing such obstacles, expanding non-traditional exports, particularly "pioneer" exports, calls for a better effective exchange rate than that for import substitutes, since today's "infant industries" are the ones that are in a good position to conquer external markets. Moreover, even if tariffs are low and a neutral approach is adopted, exports have to be compensated proportionately with direct or indirect drawbacks or lower tax rates, since the tariff amounts to a tax on exports. International competition also demands that non-traditional exports be financed at international interest rates. Successful export experiences outside the region involve the granting of incentives to pioneer firms in opening up foreign markets and a marked emphasis on external marketing activities, which include investments abroad in wholesale distribution chains and the establishment in target markets of enterprises that will import the country's products.

viii) On this basis, once the most obvious anti-export biases have been eliminated, the challenge will be to readapt incentives and the institutional framework to the behaviour of the global economy. Accordingly, the links between trade policy and policies on technology, productive development and human resources must be strengthened with a view to improving design, adherence to standards and quality of products, business and trade management, and training and technical assistance in research and development (R&D), all of which are key areas for increasing productivity and competitiveness. Likewise, rapid economic globalization demands new export promotion instruments. For example, productive investment in other countries and in marketing chains is an increasingly important factor in conquering markets, diversifying risks, reducing protectionist barriers and benefiting from economies of scale, while the systematizing and intensifying of national-level efforts to assess the quality and volume of natural resources may help develop new export sectors.

ix) As trade policies and import regimes have been liberalized, economies have become more vulnerable to unfair trade practices. Trade reform policies must therefore be accompanied by the

adoption or improvement of anti-dumping regulations, countervailing measures and safeguard clauses.

x) The adoption of the new rules negotiated in the Uruguay Round could limit the possibilities of implementing an active trade policy. However, these rules, in certain special situations, favour the developing countries, and the countries of the region should take advantage of them in order to promote exports, without prejudice to the multilaterally agreed rules, while seeking to participate actively in the process of establishing the Multilateral Trade Organization (MTO) and exploring the potential benefits of such participation in terms of conflict settlement and other mechanisms.

Part Two

PRODUCTIVE DEVELOPMENT POLICIES

Chapter VII

BASES OF A PRODUCTIVE DEVELOPMENT POLICY

1. The productivity gap and its implications

Policies that affect production systems are a factor in improving linkages between the economies of Latin America and the Caribbean and the international economy. This subject has been dealt with systematically in previous documents (ECLAC, 1990a and 1992a), which discuss the interaction between a coherent, stable macroeconomic policy, on the one hand, and micro-economic and meso-economic policies[1] and institutional reforms, on the other. Those documents focused on describing how technical progress can be applied to the production process with a view to raising productivity.

There are four general features of productivity in Latin America and the Caribbean which must be mentioned:

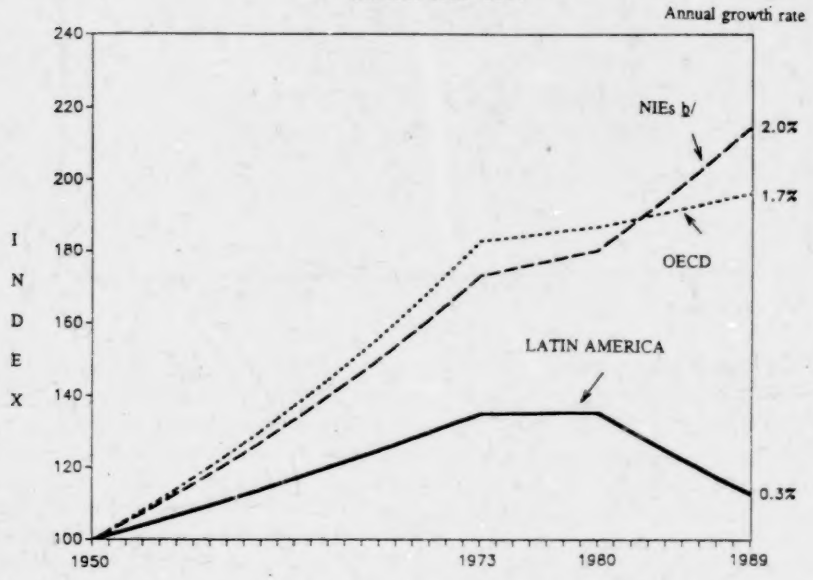
First, there is a gap on the order of 2.5 to 1 between Latin America and the developed countries (Hofman, 1993) with regard to joint factor productivity (JFP).[2] This gap is apparent both in the use of outdated equipment and obsolete production methods and in a deficient organization of labour, vertical and sometimes confrontational industrial relations, failure to improve quality, excessive inventories, unsystemic and unsophisticated marketing techniques, outdated after-sales services, etc. In fact, it shows an obvious failure to use internationally available "hard" and "soft" technologies.

Second, this gap grew markedly wider during the post-war era (see figure VII.1). In the period 1950-1989, the increase in JFP in the region was equivalent to one seventh of that of the Asian newly industrializing economies (NIEs) and at least a fifth of that of the developed countries. Moreover, even during the time of greatest economic expansion in the region (1950-1973), JFP growth reached little more than half that of the Asian NIEs, it then stagnated between 1973 and 1980 and sub-

1 In this text, macroeconomic policies are not only those which maintain the basic macroeconomic balances, but also those which establish the key prices of the economy. The term "micro-economic policies" refers to those which directly affect the operation of the firm, especially the use of the best "hard" and "soft" technology. Meso-economic policies are those which affect the firm's "habitat" and environment, i.e., they are the "horizontal" policies which influence the systemic competitiveness within which the firm operates (infrastructure, linkages with the scientific and technological system, training, finance and promotion of new exports or new markets).

2 Joint factor productivity is the production component which is not the result of either the quantitative or the qualitative accumulation of the factors of production, capital and labour. It may be considered an approximate measure of the effect of disembodied technical progress on long-term growth (Hofman, 1993, pp. 128-129).

Figure VII.1
LATIN AMERICA, OECD[a] AND ASIAN COUNTRIES: JOINT FACTOR PRODUCTIVITY, 1950-1989
(Indexes 1950=100)



Source: A. Hofman, "Capital accumulation in Latin America: a six country comparison for 1950-1989", *Review of Income and Wealth*, vol. 38, No. 4, December 1992.
[a] Organisation for Economic Cooperation and Development.
[b] Newly industrializing economies.

sequently fell, owing to the macroeconomic imbalances produced by the debt crisis of the 1980s.

Third, these productivity gaps between the region and the developed countries occur at both the global and the sectoral levels. The available data suggest that the differences in joint factor productivity among different countries are due not so much to concentration in low-productivity sectors as to the fact that almost all industrial subsectors, even those of intermediate and capital goods, are working far below the level of the best international practices. For example, data provided by the United Nations Industrial Development Organization (UNIDO)[3] show that, while in some sectors —such as petroleum refineries and related products— the region's productivity is very similar to that of the United States, in non-ferrous metals it is 64% and in rubber products and iron and steel it is around 50% of that of the United States, in the 24 remaining industrial subsectors (which represent nearly 75% of industrial value added), the region's productivity is less than 35% of that of the corresponding subsector in the United States, the average being 30%.

Fourth, such sectoral averages of course hide enormous productivity differences within the same sector deriving

3 These data were taken from UNIDO (1992) but refer to the value added per worker —a concept distinct from, although similar to, that of joint factor productivity— which makes it possible to establish orders of magnitude. It is obvious that sectoral productivity shows important country-to-country differences in the region. Nevertheless, even if the various sectors of each country are treated separately, the sectoral productivity differences among the countries of the region —even the most advanced— and the developed countries continue to be very significant.

from the tremendous structural heterogeneity of the region. On the one hand, there are marked productivity differences depending on the size of the firm. For example, in the case of Mexico, data for 1980 show that whereas small enterprises in the manufacturing sector had a productivity equivalent to only 69% of the sectoral average, in large private domestic firms productivity was 20% higher than the average, and in transnational corporations it was 78% higher. Moreover, just as there is an incomplete process of technological dissemination at the international level, so too the domestic dissemination process is slow, giving rise to considerable differences in productivity among same-sized firms in the same sector.[4] Actually, in the great majority of sectors there are some firms whose practices are very similar to the best international practices. This means that the average for the remaining firms would be substantially below the sectoral average, reflecting the tremendous structural heterogeneity of the many economic activities carried on in the countries of the region. If the process of disseminating the best practices within a country is also slow, the average productivity of the sector will be less.

2. Policy implications

The situation described above has five important implications for defining a productive development policy.

First, while the productivity gap is a reflection of a relatively lower level of development, it is also the factor that would enable countries to initiate a rapid growth process if they were able to use internationally available technologies, thereby skipping intermediate stages. In fact, late development makes it possible to take full advantage of these technologies, and the lower the point of departure, the faster the growth. That is why, sometimes, the further a country is from the technology frontier, the more quickly it will grow.[5] At present, China is expanding at a faster rate than the Asian NIEs (8% to 10% as compared with 6% per capita per year), just as the latter grew more quickly than Japan and the Nordic countries (whose take-off was in the late nineteenth century), the last-mentioned countries grew more rapidly than Germany and France (which took off around 1840 and grew more quickly than the United States which took off in 1800), and the slowest growth was recorded in the country where the Industrial Revolution began (England).

Second, in the past it was customary to attribute this wide gap to the fact that production was concentrated in low-productivity sectors, especially agriculture. This was an argument in favour of industrialization, but it did not stop there; instead, it extended to the types of industries to be promoted. There was therefore a tendency to identify a productive or industrial development policy with the establishment of new sectors which were not included on the input-output table and whose effective or potential productivity was greater than that of most of the "traditional" sectors of finished goods. This largely explains the emphasis placed, in the second stage of import-substitution strategy, on the sectors producing intermediate inputs and capital goods and the mechanical engineering industry.

4 Although part of that difference can be explained by the kind of sector in which each type of firm is concentrated, there are also important elements deriving from the capacity to use economies of scale in a given sector. For a more detailed analysis, see Casar, José and others, 1990.

5 Nevertheless, it is not the degree of backwardness alone that determines the speed of growth. On the contrary, current data suggest that there is not always a leap forward in growth. To achieve it, other conditions are required; only after crossing a certain threshold (not of per capita income but of stability, market consolidation, managerial capacity and general know-how, and a development "ethos") can an economy take off towards a steady growth period, in which the rate is inversely proportional to the degree of backwardness.

Nevertheless, the notable differences in sectoral productivity between the countries of the region and the developed countries suggest that this sectoral or "vertical" policy approach, characteristic of the past, has serious defects. It is not so much a matter of establishing new sectors which do not at present appear on the input-output table (as if all productivity came automatically out of them, which is not usually the case), as of improving joint factor productivity in existing sectors.

Third, the enormous heterogeneity existing among firms in the same sector suggests that the main challenge to a productive development policy is for the great mass of enterprises which work with obsolete equipment and outdated methods, to rapidly adopt, adapt and disseminate, the technologies at present available internationally. This is more important than the high targets for investment in research and development (R&D), which are of interest only to a small number of domestic firms that are already working near the frontier of the best international practices.[6] The essence of a productive development policy —at least at the present stage of development so far below the international technological frontier— is to expedite the process of disseminating better practices.

Fourth, since the great majority of sectors are working with a joint factor productivity that is far below the international technological frontier, the concept of comparative advantage is relatively difficult to predefine, except in obvious cases such as that of rents derived from natural resources. Actually, with such wide differences in productivity among sectors, those which can more quickly close the productivity gaps which separate them from the developed countries will ultimately have a comparative advantage. This may be acquired by one sector, provided it is capable of bridging the productivity gap with the more developed countries more rapidly than the other sectors of the same economy.

Fifth, the decline in productivity in the 1980s shows the importance, in designing a productive development policy, of keeping basic macroeconomic equilibria within tolerable margins. Actually, the instability produced by the external debt crisis and exacerbated, in general, by badly designed or implemented stabilization and adjustment policies, led to severe drops in output, which had a negative effect on the use of installed capacity, investment, engineering and design equipment, and efforts at innovation. The serious setbacks caused by these macroeconomic imbalances could not be offset by better efficiency at the level of individual firms, with the result that total productivity collapsed almost throughout the region during the 1980s. This shows that the achievement of greater competitiveness requires both microeconomic efficiency and macroeconomic stability.

3. Obstacles to overcoming the productivity gap

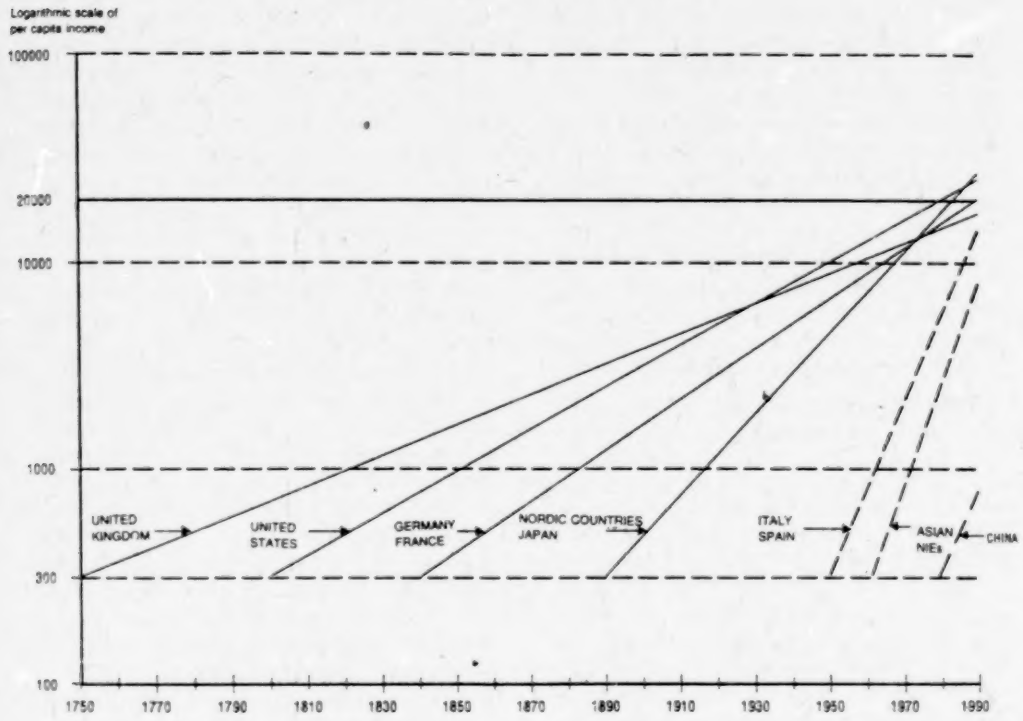
On the basis of the foregoing considerations, it may be wondered why Latin America and the Caribbean have not been able to use their advantage as late developers to skip stages, make use of the available technology and grow at much faster rates. The three standard responses to this question are, in theory, complementary rather than mutually exclusive.

6 This certainly does not negate the importance of a minimum scientific and technological infrastructure, because without it firms will be unable to identify more appropriate technologies or to acquire, transfer or adjust them quickly and conveniently. What it does indicate is that, at the current stage of development of the countries of the region, the main point is to identify the international practices most suitable for the various national economies, adapt them to the reality of each country and rapidly disseminate them. Research and development proper are more important at a later development stage, when imitation and dissemination have advanced and firms are approaching the frontier of the best world practices.

Figure VII.2

LATE GROWTH AND DEVELOPMENT: SCHEMATIC HISTORICAL EXPERIENCE

Logarithmic scale of per capita income



Source: ECLAC, Division of Production, Productivity and Management.

a) Economic policy failures

Under this approach, the macroeconomic instability which has characterized the region, the distortion of key prices, particularly that derived from the strategy of industrialization through import substitution, and the weight and preponderant intervention of the public sector in managing the economy explain the comparatively poor performance of the region during the period in question. As a result, this orthodox approach argues for macroeconomic stability, trade opening and privatization, while restoring the private sector to its prime role in the economy according to the traditional rules of the market.

b) Problems at the level of firms

This second approach focuses the analysis at the opposite extreme: in firms. On the one hand, it claims that the region has suffered "capitalism without capitalists", i.e., it has lacked a forceful entrepreneurial class. This explains the existence of such large differences in joint factor productivity between Latin America and the developed world. Moreover, it was this absence of innovative entrepreneurship that prompted so many governments to intervene increasingly in the economy to

offset the lack of entrepreneurial drive. On the other hand, it emphasizes the difficulty (cost) for a single enterprise to identify, and subsequently internalize, the technology, processes and production methods available at the international level that are most suitable and easily adaptable, and the most appropriate market niches for producing competitively. There is a notable underinvestment in this area, therefore, with the great majority of enterprises waiting for others to act first, so as to imitate them. Since the identification and dissemination of hard and soft technologies is a "public good", there would be ample room for adopting macroeconomic policies designed to promote the "socialization" of costs and the rapid dissemination of such technologies among firms.

c) Market failures, externalities, public goods and problems of industrial organization

This third approach refers to the advantages of emphasizing policies which improve the functioning of factor markets (meso-economic or "horizontal" policies), rather than policies designed to develop the markets for specific products. The need to focus State action on the most critical bottlenecks explains the desirability of emphasizing the correction of the more serious failures of factor markets, which affect all sectors. Likewise, there will always be room for policies aimed at internalizing significant externalities, providing public goods, and regulating oligopolistic markets for non-tradable goods (especially, in the last case, most modern infrastructure: telecommunications, ports, irrigation, electricity, etc.) which seriously affect the systemic competitiveness of tradables.

4. Theoretical justification of an active productive development policy

Nowadays in Latin America and the Caribbean, there is broad consensus concerning some general parameters which facilitate the implementation of measures for modifying the supply of exportable goods. These include the maintenance of basic macroeconomic equilibria and trade opening aimed at utilizing economies of scale and incentives for healthy competition. The debate tends to centre on how to define these policies more precisely, determine the pace and intensity of their application and, in particular, decide whether they by themselves are sufficient incentive for promoting a change in production patterns. ECLAC has maintained that, in order to overcome the productivity gap referred to above, macroeconomic and trade policy ought to be complemented by a mix of active policies which make use of the technological and organizational advances of the more developed countries in order to skip stages, as generally happened in the successful late developing countries. More specifically, it considers that productive development requires, in addition to sound macroeconomic and liberalization policies, two groups of complementary actions: "meso-economic" or horizontal policies focused on improving markets and filling the existing gaps therein, and micro-economic policies which help to internalize externalities related to the identification, adjustment and dissemination of the best internationally available technologies and practices. Without such micro-economic and meso-economic policies, and without suitable macroeconomic management and international integration, the restructuring necessary for initiating accelerated growth will be unnecessarily slow and inefficient.

Indeed, liberalization and restructuring will either benefit or clearly hurt some firms and activities in both the short and the long term. Nevertheless, the effect of these processes on other firms and activities may be very ambiguous: first, because it is not clear whether the key prices prevailing at the time the measures are taken will remain unchanged over the long term, and second, because many potentially competitive enterprises and activities may be adversely affected in the short term until they are able to identify, introduce and assimilate the changes

necessary for acquiring competitiveness in the domestic market and even abroad. This may be the case both for enterprises and activities that are potentially competitive in efficient import substitution and for potential producers of non-traditional exports. The speed of their restructuring and, in some cases, their very survival will depend on the information and human and financial resources at their disposal. Hence it is important that key markets —those for technology, capital assets, human resources and foreign currencies— operate at optimal levels. Otherwise, the more imperfect these markets and the greater the uncertainty with regard to the seriousness of the adjustment and liberalization process and the permanency of the key prices in force, the more likely it is that potentially competitive firms will be unable, for lack of time and resources, to neither carry out the restructuring necessary to compete at the national level or to penetrate external market niches in which they could acquire a competitive advantage. This situation may be aggravated if there is a recession and abnormally high interest rates.

On the basis of the foregoing, it may be concluded that the restructuring process that followed the outbreak of the debt crisis was very costly at the beginning and slower in the recovery phase, because macroeconomic and trade policy was virtually unaccompanied by productive development policies (micro-economic or meso-economic). Moreover, when liberalization was complemented by a sound updated industrial policy, it contributed to a number of the region's most notable export successes, including those in the sectors producing automobiles and parts, wood, paper and pulp. Nevertheless, these last cases were exceptional. Generally speaking, with liberalization almost all the industrial policy of the past was eliminated,[7] most of the time without being replaced, instead of being adapted to the new requirements; for example, it would have been possible to adopt policies linking incentives to export performance or to productivity improvements and promoting non-traditional exports, the development of human resources, technological dissemination and efficient sources of financing. The main theoretical and empirical arguments in favour of a productive development policy more in line with the requirements of the 1990s are presented below.

a) Market failures

i) *The technology market.* Modern versions of development theory emphasize the concept of endogenous technological change in firms, generated by their investment both in acquiring and transferring technology and in research and development. This approach refers both to "hard" technology, i.e., that incorporated into machinery and equipment, the day-to-day efforts being made in the field of engineering to improve productivity or product design, and to "soft" technology, which includes improved management techniques, quality control, industrial relations, "just-in-time" production, and other elements.

This is a field in which market forces on their own tend to behave suboptimally. First of all, there is an intrinsic asymmetry with regard to information between the technology supplier (who knows what it is really worth) and the buyer (who is ignorant of the real value of the new technology, is unfamiliar with it, and depreciates it when he learns more about it because he can try to reproduce it), and this makes it difficult for the market to arrive at a correct valuation. Secondly, whereas in an ideal world the optimal decision would be to develop or acquire, all at once, all the technical know-how available and to ensure that all the other economic agents had ac-

7 This was a reasonable decision, because the policy tended to have no time-limits, often led to the production of items with scant possibilities of developing comparative advantages and was basically oriented towards the domestic market, which for many activities, except in Brazil and Mexico, was too small to permit the minimum scales required for an efficient output.

cess to it immediately, in the real world all agents would prefer that the others absorb the costs of developing a new technology or of identifying the technology most suitable for introduction into a developing country, so that they could then imitate it at a marginal cost. Thirdly, even where there is a private interest in developing a new technology, this technology may be so specific to the firm in question that the latter is not afraid that the technology will be imitated and disseminated but the firm's scale of production may be insufficient to justify making significant research and development efforts, with the result that there will tend to be underinvestment both in the acquisition and in the development of new technologies.

Indeed, technical know-how and information are goods, whose benefits cannot be completely appropriated by those who create them; moreover, they are non-exclusive goods which may be used simultaneously by several users (Romer, 1990).[8] This results in underinvestment by the private sector in the introduction of a new technology into a country or in the development by that country of its own technology, and this underinvestment can be only partially and inadequately offset by direct State investment in research on and the development of new scientific and technical know-how and by the establishment of institutions as mechanisms for protecting patents and trademarks.

Similarly, a country's capacity to adapt international technology to its own conditions, make better use of available natural resources, climate (in the case of agriculture and tourism) and the size of its markets, and deal with the relative shortage of factors depends on the quantity and quality of its researchers and on the interrelationship between scientific and technological research centres and the production system. The opportunities of acquiring and retaining competitive advantages will ultimately depend on the quality of the scientific and technological infrastructure and its links with enterprises in the production system.

ii) *The human capital market*. A strong demand for technology requires a dynamic supply of skilled manpower that is capable of absorbing new know-how and productive innovations. Although public investment in human resources is adequate, private investment in such resources tends, intrinsically, to be insufficient.

For one thing, firms are unwilling to finance general training services which benefit only the worker; in other words, a firm will tend to concentrate its investment in training in its area of specialization so that it can derive the full benefit, while its investment in general training will tend to be suboptimal. Although general training raises labour productivity in many enterprises, it usually benefits the worker more than the enterprise itself. The result is that firms tend to limit training, at this level, to the minimum needed to teach workers how to use new equipment or procedures properly. For the same reason, small firms will tend to offer little formal training, because virtually all they could provide would be general education and that could be used by the worker in numerous other firms. Therefore, training in small enterprises tends to be limited to learning by doing, and the worker pays indirectly for this type of implicit training since he receives a lower wage than that paid in bigger firms.

Investment by the potential beneficiaries —the workers— is also inadequate because they cannot offer the necessary financial guarantees in order to borrow money to pay for training for themselves or their family members, and this hinders

8 Exclusion from the use of these goods is not always feasible, even when there is an appropriate institutional and regulatory framework for industrial property matters. Exclusion is much more complex if such an institutional framework does not exist, or if the courts only pay it lip-service. The prevailing market structure in each industrial branch is influenced by the appropriability of, or exclusion from, the fruits of technological change, and this raises problems which the competitive model cannot solve. Government regulation and coordination then come to the forefront.

the development of a private lending market for human resources training (ECLAC/UNESCO, 1992). As a result, private investment in human resources is insufficient; the fact that it is limited to the family's capacity to finance itself is a serious obstacle, since in order to obtain training a family must pay both the direct cost of the courses and the opportunity cost (income not received) of the time devoted to study.

iii) *The long-term financial market.* National financial markets are inadequate and embryonic, even in countries without large macroeconomic imbalances and with a significant amount of institutional investment. First of all, in practice, there is no long-term financial market except for the few enterprises with access to stock exchanges. The problem is not limited to small and medium-sized enterprises (SMEs) but affects the bulk of a country's firms. Secondly, both the domestic and international financial markets are asymmetrical (see Part Three of this document): there is access to finance in times of boom, but such access virtually disappears when resources are needed to deal with restructuring in difficult situations. Third, access to the financial market is very segmented, because it depends more on guarantees (the result of past performance) than on projections of future profitability. Thus, the bulk of investments by firms are self-financed, a situation which causes productive inertia instead of restructuring in favour of enterprises with better prospects.[9] Fourth, there are serious obstacles to the financing of new enterprises and to technological innovation in the area of either products or processes.

One of the main factors that explains the above-mentioned bias in the financial system is the conflict between the obligation on this system to correctly gauge the creditworthiness of potential borrowers and the difficulties it faces in obtaining the information it needs to perform this task effectively; the seriousness of the problem increases in activities which require long financing terms. If the information available to the financial agent to evaluate the future cash flows of a project is insufficient or if access to such information raises the transaction costs, the agent is likely to make use of the guarantees brought by the borrower as a critical indicator of his creditworthiness. Thus, in the case of new, short- or long-term projects, the requirement of guarantees may be increased, and this consolidates the bias. This procedure may hinder the implementation of profitable projects and lead to underinvestment and a lower rate of effective growth.

The above situation may be aggravated when financial deepening coincides with the presence of financial conglomerates. Together with presenting new challenges of regulation associated with systemic risk, conflicts of interest, cross subsidies or implicit endorsement, the action of these conglomerates can increase the above-mentioned biases.

Finally, the development of long-term financial markets is discouraged, on the one hand, by macroeconomic instability and, on the other, by a lack of institutional investors, such as pension funds and insurance companies, with an interest in assuming long-term commitments, and a shortage of specialized bodies capable of evaluating longer-term instruments, projects and investments.

iv) *The foreign exchange market.* There is also underinvestment in the generation of new exports and in the opening of new markets abroad, since such activities entail high costs in terms of time and resources for individual producers, while the first producers to open a new market or introduce a new export cannot reap the full benefits of such activities; obviously, these costs are proportionately higher for SMEs. Likewise, the absence of a medium-term futures market for foreign exchange in-

9 For a discussion of a series of proposals for creating markets or filling the large gaps in the region's financial markets, see chapter VII of ECLAC (1992a). In the case of small and medium-sized enterprises, specific proposals such as leasing, factorization, risk capital funds, secondary stock-exchange markets and credit cards for small businessmen are included.

creases uncertainty as regards the permanency of the key prices in force, particularly the real exchange rate. This necessitates an exchange rate policy which, if an exchange rate insurance for exports is not feasible, serves to signal to exporters foreseeable medium- and long-term macroeconomic trends. As stated above, exchange rate uncertainty tends to have a greater negative effect on non-traditional exports and on domestic and less diversified firms.

b) Problems of industrial regulation and organization

The aforesaid problems are particularly serious in the case of small and medium-sized enterprises. Actually, there is very little incentive to invest time or resources in penetrating new markets or in studying how to acquire new and better technologies, because such costs are not justified at the level of a single small firm, although investment would be very appropriate for the firms in that sector as a whole. This would justify programmes to encourage the relevant association or chamber of commerce to carry out surveys of external markets and look for more efficient technologies for subsequent dissemination via extension programmes.

Conversely, these problems do not greatly affect transnational corporations or those belonging to economic groups. Although enterprises that form part of national economic groups or conglomerates solve the problem of access to finance by grouping together, this privileged access may prompt them to increase their economic power by buying up very diverse enterprises with good prospects but little capital, so that they receive monopoly rents rather than generating wealth. The activities of conglomerates therefore require a regulatory framework that ensures or increases competitiveness.

In the case of transnational corporations, there is no problem with penetrating external markets, since one of their attributes is that they have access to these markets; in general, they also have no problems of access to capital markets or to modern technologies. The difficulty in such cases is that the corporate strategy of globalization may not coincide with that of the countries in which they are established. Reconciling these interests is a fundamental objective of a national economic policy aimed at attracting a great number of transnational corporations, of diverse origins and well-adapted to the country, to the sectors which are deemed to have priority and the activities which offer the best learning and dissemination opportunities (ECLAC/UNCTAD, 1993c).

c) Increasing returns and strategic complementarities

A firm's competitiveness depends not only on its own productivity but also on that of its environment, because the latter determines systemic productivity. Thus, no matter how efficient a firm may be, its competitiveness depends on the productivity of its suppliers (in terms both of quality and of prices and timely delivery); the overall level of education and, consequently, the efficiency and speed with which its workers can be trained; the extent to which the financial system to which it has access meets its needs; domestic transport costs and the efficiency of the country's port system (as regards the cost both of imported inputs and of shipments abroad); the costs and efficiency of the electric power generation system and of other public utilities which affect costs; and the telecommunications system, in terms of costs, speed and efficiency.

All these factors, although external to the firm and hence beyond its control, may be equally or more important than productivity to its international competitiveness. Indeed, these factors are in a sense public goods because, since they generate externalities and are not subject to the firm's full control, it is not in the firm's interest to take unilateral action with regard to them. These are functions which require collective action, whether by trade unions or by the regional or national government.

Increasing returns to scale at the level of the firm generate external financial

economies at the aggregate level, and hence produce strategic complementarities which make it possible to justify coordinating the activities of private agents with the economic authority. The availability of increasing returns to scale and of strategic complementarities produces externalities and coordination costs which decentralized market signals cannot take fully into account. No doubt these anomalies vary considerably from one industry to another, and, as Krugman (1986) states, "if there are important rents in certain sectors, trade policy can raise national income by securing for a country a larger share of the rent-yielding industries". The same could be said for actions aimed at productive development.

The presence of increasing returns at the level of the firm precludes working with competitive models. Therefore, the consideration of alternative scenarios (such as imperfect competition or oligopoly) is a distinctive feature of modern theories of growth and international trade. The State's role, which is regulatory as well as coordinating, has again become of vital importance in terms of, for example, topics related to industrial property, anti-trust legislation and anti-dumping regulations.

5. Practical reasons for a policy of productive development

In the first place, in most latecomers to development, the State has played an active, efficient role in perfecting or improving markets, providing substitutes for them and creating an environment conducive to investment and innovation. In the past, Germany and France, for example, took measures to promote a close relationship between the banking and industrial sectors. Japan also, at the end of the nineteenth century and again following the Second World War, promoted imitation or licensing of technology with the support of the Ministry of International Trade and Industry in order to concentrate resources on priority sectors. Similar actions were taken more recently in the Republic of Korea and, to a lesser extent, in Taiwan Province of China and in Singapore, where high export performance incentives were established.

Secondly, these successes are not automatic, nor are they always assured. However, they may function in the latecomers to development precisely because the road to be followed is fairly clear. Although the technological frontier continues to advance in unexpected directions, since these countries are so far behind, they do not have to make efforts to be at the forefront of technology; rather, it is more a matter of mastering modern, mature technologies on which future technological advances will be based.

Third, the public sector also has its defects: it does not have unlimited or privileged knowledge. Its efforts should therefore extend only so far as its real capacities allow. Consequently, determining how much State intervention is warranted is an empirical matter, not a theoretical one, and depends on the real capacities of the public sector and the scope of market failures. Experience suggests that State intervention will be more effective when it is i) "market friendly" and does not try to supplant the market, and ii) selective and transparent, because of the State's limitations and because there is a need to prevent an avalanche of private demands which seek to control easy rent-seeking activities instead of creating wealth.

Fourth, experience also indicates that there is a wide variety of alternatives regarding State intervention, including: i) development led by conglomerates (Republic of Korea) or by small and medium-sized enterprises (Taiwan Province of China); ii) growth led by domestic firms (Republic of Korea, Taiwan Province of China and Japan) or by direct investment by public enterprises and transnational corporations (Singapore) which must comply with certain performance requirements; iii) promotion of comparative advantages which stress the importance of both supplying mass markets and concentrating on niches or specialized segments;

iv) development propelled by exploitation and processing of natural resources with the later establishment of backward or forward linkages, or even sideways linkages[10] (Denmark, Sweden and Finland, among others in the past; Thailand, Malaysia and Indonesia at present), or an initial development of manufacturing when significant natural resources are not available (Japan, Republic of Korea and Taiwan Province of China); v) exporting since the beginning of the industrialization process or import substitution at an early stage, subject to increasing external competition, in order to export subsequently; vi) an initial opening based on promoting exports while liberalizing imports of inputs and capital goods, followed by a wider trade opening later (in the case of most of the Asian NIEs) or a free market almost from the start (Hong Kong and Singapore).

Fifth, although a large part of the import substitution strategy lacked economic rationality (frequently "each sector was given the protection it needed" without linking it with the social benefit), it permitted important advances in the region's industrial development. In fact, there are sectors —even technologically sophisticated ones— which show that a dynamic advantage can be acquired in a reasonable amount of time. The Mexican and Brazilian automobile industries are good illustrations of this. Also, there are many "traditional" labour-intensive sectors (food processing, apparel, footwear and textiles, and production of durable goods such as appliances, inputs and even capital goods, especially if they are custom-made) which have become internationally competitive, either in the domestic market, through efficient import substitution, or in the international market, through exports.

Sixth, experience suggests that competitive advantages can be acquired through productive development policies which strengthen market forces rather than supplanting them, provided that several requirements are met, including the following:

i) That the incentives are transitory, for only when the obligation to compete internationally is established is it feasible to persuade entrepreneurs to adopt a favourable attitude towards productive activities and not towards those that are merely rent-seeking.

ii) That the scale of production is sufficiently large, i.e., that there is a large domestic market (e.g., traditional firms in most countries or the automobile assembly industry in Brazil and Mexico), that exports have been taken into account from the start (automobile engine plants installed in Mexico since the end of the 1970s, or other product lines aimed at foreign markets as a result of export-promotion policies, as in Brazil and Colombia) or that an industrial commodity is produced which is easily exportable if there is insufficient domestic demand (a considerable part of the production of intermediate inputs in Argentina and Brazil).

iii) That, generally speaking, the use of obsolete or rapidly evolving technologies is avoided. In the case of the former, this is because the comparative advantage would be based only on maintaining low labour costs and could be quickly lost as the technology changed. Likewise, sectors where technology is making giant leaps forward should generally be avoided because, by the time this technology has been mastered, the best international practice will have already moved forward significantly; this would appear to be the case of the information sciences industry in Brazil, the pharmaceutical industry in

10 Sideways linkages are movements towards the production of i) complementary products (e.g., from garments to footwear because they have similar distribution channels); ii) different products which use a similar technological base (e.g., from bovine insulin to porcine insulin and then to human insulin, or from specialized machinery for separating and selecting different grades of coffee beans to electronically selecting all kinds of beans by colour, texture or size); and iii) close substitutes (e.g., from single- to multi-flavoured juice or from regular to "light" beer).

other countries, or the production of spare parts or capital goods for producers of intermediate inputs, where few plants of this last category exist and where the investment in them is small. Experience therefore points to the importance of adopting a relatively advanced but already proven, mature technology, as in the case of automobile engine manufacturing in Mexico, so that the technology can be mastered and even adapted before it is replaced by a very different one. Indeed, it is a matter of avoiding dead-end learning processes (i.e., the use of outdated technologies) or those in which countries cannot keep up with the best international practices owing to the rapidity of technological change, or falling into the use of obsolete or polluting technologies.

Technology should therefore be relatively advanced and proven and should allow a country, within a reasonable period of time, to start producing according to the standards of the best world practice and to remain on the international technological frontier.

6. Summary

The traditional industrial promotion instruments used in the region, such as high or non-time-limited tariffs, import quotas, local subsidies and the provision of goods and services by State corporations at subsidized prices (for example, electricity, petroleum, steel) are no longer valid. The loss of importance of these instruments was due to several factors: i) the lack of economic rationality in their levels and periods of application; ii) the abuses to which they gave rise during part of the period when the industrialization strategy based on import substitution was in force; iii) the tight financial constraint on the public sector during the adjustments of the 1980s; and iv) the fact that most of the policies which involved the use of these instruments came into conflict with the policies that began to apply in the mid-1980s (trade opening, financial liberalization, privatization and deregulation).

As for alternatives, an analysis of several experiences and policies designed to increase the competitiveness of the production system indicates that future policies in the region will need to have a high degree of flexibility and pragmatism, combine elements of different scope (segments, sectors and neutral policies) and give priority to solving specific problems rather than to global strategies. An appropriate mix of private and public efforts is, of course, a pre-condition for effectively implementing and correctly designing these policies. The productive development policy proposals formulated within and outside the region in the 1980s and early 1990s, as discussed in the following chapter, make it possible to identify a series of elements which should be taken into account in elaborating and implementing future competitiveness policies (Peres, 1993).

Chapter VIII

PRODUCTIVE DEVELOPMENT POLICY OPTIONS FOR THE 1990s

There is a wide range of alternative instruments for achieving faster and more effective production restructuring. In particular, there are some instruments which fulfil the three conditions of avoiding the excesses of the past, complying with the consensual principles referred to in the preceding chapter, and having been successfully tested, above all in the Asian NIEs.

What is required in order to promote competitiveness and close the productivity gap with the developed countries is not only sound macroeconomic and trade liberalization policies but also an active productive development policy which includes:

i) *"Horizontal" or mesoeconomic policies*, that is, policies which support the systemic competitiveness of the environment in which the enterprise operates, especially those focused on filling the gaps and overcoming the most critical bottlenecks in the factor markets, such as policies for innovation and the dissemination of technology, training, export promotion, financing and infrastructure development.

ii) *Microeconomic policies* which directly support the operations of enterprises and, in particular, the use of the best technologies. Learning and restructuring in the areas of technology, organization, quality control and marketing all require a heavy investment of time and physical and human capital. The essential role of a modern industrial or productive development policy is to facilitate this learning and restructuring, reinforcing rather than replacing the market forces.

In order to apply this set of policies it is necessary to get away from the idea that when it comes to meeting the challenge of competitiveness there are only two kinds of firms: those which are prepared to restructure and transform themselves into competitive enterprises, as many are already doing, and those which will disappear because of the difficulties they encounter in adapting to new circumstances or because of their lack of motivation to do so. Although the attitude that giving the market forces free rein is sufficient of itself to ensure that inefficient enterprises will disappear and competitive enterprises will survive is not always explicit, the lack of support policies which would help enterprises to become competitive shows that this attitude still prevails in practice. Nevertheless, reality shows that a large proportion of the region's enterprises belong to a third group: those which have the potential to be competitive, but which need support in order to improve their product design, reorganize their production processes and acquire the capacity to respond quickly to changes in demand: in short, to strengthen their competitiveness. These are the enterprises on which policies to promote competitiveness should concentrate.

1. Policies to further innovation and the dissemination of technology

a) *The situation of enterprises at the beginning of the 1990s*

Entrepreneurial performance in the region is tending to display increasing dualism. In order to overcome the challenges and take full advantage of the opportunities referred to earlier, Latin America and the Caribbean must considerably increase their efforts in the area of technology.

On the one hand, there are large private national groups, subsidiaries of transnational corporations and many small and medium-sized enterprises (which often act as subcontractors for the first two types of companies) which are engaged in an intensive process of modernization reflected in the growing competitiveness of such activities as the automotive industry in Mexico, the aluminium industry in Argentina, the paper and pulp industry in Brazil or the domestic appliances industry in Chile. Even in traditional sectors, many companies have shown a great capacity for modernization, as in the cases of the ceramic products and leather industries in Uruguay, the footwear industry in Chile, textiles and clothing in Colombia, and textile and canned food in Central America. Even in situations of acute and prolonged macroeconomic crisis combined with trade liberalization, as in the case of Brazil at the beginning of the 1990s, substantial restructuring processes and increases in competitiveness are to be observed (see box VIII.1).

In contrast to this relatively promising picture, however, it is clear that in a number of countries and sectors the competitiveness of regional manufacturing is still only incipient and that innovation is the rule only in a very limited number of enterprises.[11] In particular, for the three largest economies of the region, the change in their trade structure points to a relative loss of international competitiveness in the 1980s in production sectors that are know-how and capital goods-intensive, in spite of the considerable advances achieved in sectors producing natural resource-based goods or in the motor industry (Gurrieri, 1993; Katz, 1993).

At the enterprise level, the slowness with which many firms in some important production sectors have responded to the new pressures of the more competitive environment created by the increasing trade liberalization of the region's economies is cause for concern. This is especially true in the case of enterprises which do not carry on export activities, either because of problems of internal competitiveness or for systemic reasons. An example of this situation, even in a modern activity producing goods based on abundant natural resources, is the Venezuelan chemical and petrochemical industry. Out of a total of 113 enterprises highly representative of the production and employment generated in this industry in 1988 and 1992, about 40% lacked basic information on technological, commercial, organizational and even accounting problems, and one-fifth did not even attach importance to this fact or showed no awareness of the need for such information (Pirela, 1993).[12]

Moreover, nearly two-thirds of the enterprises exhibited characteristics, both before and after the structural changes initiated in 1989, which justified describing them as "passive" or "isolated from the

11 Some recent data point to growing private participation in the costs of research and development: in the case of Mexico, for example, data for 1992 indicate participation of 22%, which, although still far below desirable levels, marks a clear advance compared with the figures below 10% registered in the 1980s.

12 Although this description could also be applied to some enterprises in developed countries, the situation is particularly serious in a context —like that of the region— marked by increasing international competition and a tendency towards overvalued exchange rates (see chapter XI).

Box VIII.1

ADJUSTING FOR SURVIVAL IN AN ENVIRONMENT OF SEVERE MACROECONOMIC IMBALANCES AND ECONOMIC STAGNATION: THE PROGRESS OF BRAZILIAN ENTERPRISES TOWARDS GREATER COMPETITIVENESS

During 1993, ECLAC cooperated with the Government of Brazil in a broad study carried out by Brazilian specialists on the competitiveness of the manufacturing sector. The study showed that big domestic and foreign firms had an extraordinary capacity for achieving substantial increases in productivity and quality in order to cope with the economic turbulence of recessions, four-digit inflation and trade liberalization experienced over the past six years.

The study confirmed the trends suggested in the last two years by a series of isolated indicators, all of which pointed to important improvements during that period in the competitiveness of the manufacturing sector. For example, not only has there been a sharp increase in the activity of technological consulting enterprises but also, according to the data provided by the Brazilian Geographical and Statistical Institute (IBGE), during the period 1991-1993 productivity increased by more than 25%, in contrast with the stagnation of labour productivity during the previous five years. This study has contributed enormously to an understanding of the process, as it provides a detailed examination of its internal operation.

The present economic turmoil is limiting progress by restricting investment in fixed capital. Moreover, there has not been much progress in certain areas which are critical for long-term competitiveness, such as training and technological research, although improvements are foreseen in the near future in most of the enterprises included in the study.

Nevertheless, the data given by the study indicate substantial progress in a series of basic determinants of competitiveness. Considerable rationalization of costs is being achieved through: i) contracting of support services outside the enterprise; ii) specialization in fewer product lines, but at the same time incorporating more models and more rapid changes within them in areas where the firms have comparative advantages; iii) de-verticalization; iv) elimination of bottlenecks; v) more efficient use of inputs and consequent reduction in waste; and vi) reduction in levels of authority (from 6 to 5). Moreover, enterprises have placed great emphasis on measures to ensure and control quality, including greater technological refinement, better adjustment to technical specifications, better use of consultants, and a radical change of attitude towards suppliers. Lastly, production has begun to concentrate much more on the customer, as is demonstrated by greater durability of products, shorter delivery times and quicker preparation and introduction of new products.

Given the stagnation of demand, it is natural that these efforts should have been concentrated on certain areas which require little new investment in fixed capital. Nevertheless, the benefits of the current adjustment should not be underestimated, as it has spread throughout the manufacturing sector and has advanced very rapidly since 1990. Moreover, it has helped to avoid a serious collapse of the sector by increasing the capacity of Brazilian enterprises to cope with trade liberalization, in an unfavourable international environment and a difficult macroeconomic situation, by achieving substantial increases in competitiveness. Furthermore, although it has not contributed to significant technological progress —for example, there are few examples of flexible automation—, it represents a good beginning which will ensure the introduction of technological progress in the future, once investment increases and enterprises begin to invest in the so-called third industrial revolution and reap its benefits to the full.

Source: R. Bielschowsky, "Adjusting for survival: domestic and foreign manufacturing firms in Brazil in the early 1990s", Santiago, Chile, ECLAC, 1993 (unpublished); R. Baumann, "Exporting and the saga for competitiveness of the Brazilian industry", Santiago, Chile, ECLAC, 1993 (unpublished)

sources of technological dynamism" (see table VIII.1).[13] In addition, out of a subgroup of enterprises (54) which formed part of the sample in both 1988 and 1992, only a little more than one-third made positive changes and tended to become more active, while the rest regressed, in that their learning capacity diminished or they did not see the need to change their behaviour.

Other studies with similar goals show that in very important sectors there has still not been sufficient adaptation of the prevailing business culture to the new reality of international competition to enable production units to perceive that there is a clear and direct relationship between their technological behaviour and their economic performance.[14] Although there may well still be some uncertainty about the wisdom of seeking to adapt to a new environment which may be reversible, it would seem that the main reason for the relative passivity observed is inertia, the correction of which will require policy measures that recognize the structural dualism evident from the examples given.

The perception by enterprises that they are confronting an increasingly competitive environment plays an important role in their technological modernization decisions. Thus, in the garment production sector in Chile, Mexico and Venezuela in the early 1990s, we can observe growing concern by firms to acquire modern machinery and equipment. This is due to the combination of trade liberalization, exchange rates with a tendency towards revaluation, sales pressure from international enterprises facing recession or slow growth in their main markets, and the progressive development of trade mechanisms making it possible to take greater advantage of international prices. All these factors reduce the trading opportunities of the customary suppliers of the domestic market. The increased competitive pressure is reflected in efforts to reduce costs, and in doing this there is naturally a tendency to concentrate on those cost factors which can be reduced by introducing modern machinery.

Accordingly, as economies stabilize, wage costs rise and there is less room for increasing competitiveness through significant exchange rate devaluations, enterprises in these sectors confront the need to adapt their technologies. This process of reaction by enterprises would naturally be easier in a climate of economic growth, with access to financial resources at reasonable cost.

The above analysis indicates that an appropriate system of incentives is a necessary but not a sufficient condition for stimulating technological innovation, and must be supplemented with the development of a special set of institutions.

b) Institutional experience

Although a number of problems still persist in the technological culture and behaviour of the region's enterprises, there is a wealth of institutional experience in the development of national science and technology systems, technology management,

13 "Passive" enterprises are those which show considerable technological backwardness and do not carry out internal technological activities or develop external linkages which would enable them to overcome that backwardness, while "isolated" firms are those which make technological efforts but do not link them up with sources outside the enterprise that would make it possible to give them a boost. The latter firms, which have an interesting record of technological learning in the past, seem to be over-adapted to an economic environment which is becoming less and less relevant to their activities, while they have been unable to establish linkages with outside sources of technology (as enterprises which are "technologically dependent on the outside world" have done) or to transform themselves into "active" enterprises (i.e., enterprises well adapted to the present environment and with close links with national research centres).

14 See, for example, Prochnik (1989) in the case of the Brazilian textile and garment industry and Guerguil, Macario and Peres (1993) in respect of the garment industry in Chile, Mexico and Venezuela.

Table VIII.1
VENEZUELA: TECHNOLOGICAL DYNAMISM OF CHEMICAL AND PETROCHEMICAL ENTERPRISES, 1988 AND 1992

Type	Number in 1988	Number in 1992	Technological characteristics	Comments
Active	28	20	Some capacity for design and technological experience. Main competitive strength is customer service	Large enterprises suffer from shortage of qualified staff. Maintain links with universities
Technologically dependent on the exterior	22	32	New products are the key to their competitiveness.Greater weight of competitive markets	Produce mass-consumption goods. Many foreign enterprises or joint enterprises with foreign control
Passive	19	18	Technological lag of 5 to 15 years.Competition based on prices	Concentrate on producing one line of goods with mature technology
Isolated or non-differentiated	44	43	Adaptation to the environment based on customer service. The "professional challenge" still exists	Good technological level, but are isolated
Total	**113**	**113**		

Source: A. Pirela, "De la taxonomía empresarial a la política industrial: los efectos del ajuste estructural en la cultura tecnológica de las empresas", paper presented at the international seminar on "Entrepreneurial conduct and technological culture in Latin America: the chemical and petrochemical industry", Caracas, ASOQUIM/Centro de Estudios del Desarrollo, 1993.

linkages between universities and industry, "enterprise incubators", technology parks and local systems of innovation and international cooperation, and these initiatives deserve special attention as successful and intra-regionally transferable policy instruments (Peres, 1993; Dini and Peres, 1994). The following conclusions can be drawn from this experience:

i) The development of direct action at the enterprise level is the key to promoting organizational change and the absorption of new technologies. What most restricts the introduction of new technologies is the insufficient demand by firms for them, and this is particularly true for important industrial sectors in the region which utilize mature technologies, readily available in the international market, but lack adequate information on the available international supply and its potential impact on their profitability. The problem therefore is how to fill this gap and stimulate demand by firms. There are two successful examples in the region of institutions directed towards this end: Costa Rica's experience with "technology management nuclei" shows that these can be an efficient and transferable instrument,[15] while Chile's experience with the establishment of "pilot" enterprises shows that they can stimulate new private investment in areas

15 This initiative, carried out by the Centre for Technology Management and Industrial Information Systems (CEGESTI), is based on teams of experts in technology and management who work directly with the senior management of enterprises to improve their competitiveness by means of increased productivity, organizational changes and technology management in general.

which have been insufficiently developed because of the inadequate information available in that sector and thereby create a demand for technology transfer and adaptation services.[16]

ii) Technology-based enterprises originating from major public research and development centres have proved to be an efficient instrument for spreading technological capacity; in some cases it has been observed that the development of "enterprise incubators" or technology parks has helped such enterprises to mature. The science and technology bodies of some countries of the region and their associated funds have contributed financing for such efforts on the basis of shared benefits and risks.[17]

iii) National science and technology bodies have tended to establish closer links with the production sector, although much remains to be done before their activities can have a significant impact on productive activity as a whole. These bodies have concentrated their attention on policy instruments connected with the financing of training and research and development at the enterprise level, particularly in small-scale and micro-enterprises. The conditions of this financing (interest rates and guarantee requirements), although better than those prevailing in the market, in many cases still do not fully incorporate the risk factor and the externalities present in technological activity.

iv) The management of cultural variables is decisive in efforts to link production firms with top research centres. The most important factors involved are the development in such centres of an environment more conducive to interaction with enterprises and the consolidation of broad, long-term policies and institutional support to regulate that relationship.

v) The most important role of international cooperation in the technological field is to act as a catalyst for promoting joint technological efforts between centres of excellence, between centres and enterprises, and between enterprises located in different countries.[18]

vi) The development of local systems of innovation in countries of the region, despite the successes achieved, has run into major problems: first, neither businessmen nor policy makers fully recognize the role that cooperative efforts can play in the effective implementation of policies for promoting such systems, particularly those made up of small firms; second, the weakness of local economic and social structures, combined with the limited capacity for implementing State policies, promotes a tendency on the part of enterprises to take advantage of the collective effort without contributing to it ("free riders"); third, the public institutions responsible for promoting innovation have centralized management structures which are not efficient for identifying the needs of enterprises in unstable and dynamic contexts; and fourth, there is a conspicuous lack of coordination between promotion policies and the specialization and complementation needs of the firms participating in efficient local systems of innovation.

c) Policy lines

A review of technological behaviour and institutional experience in the region

16 A well-known example of "pilot" enterprises is provided by the Chile Foundation, whose initiatives in the creation of enterprises have demonstrated the potential profitability of activities which the country's business class did not perceive as profitable (see box V.2 and Huss, 1991).

17 Two examples of the promotion of enterprise incubators are the Incubator Programme for Technology-Based Enterprises (PIEBT) of the National Council for Science and Technology (CONACYT) of Mexico, and the Technological Enterprises Programme of the National Council for Scientific and Technological Research (CONICIT) of Venezuela.

18 Two important experiments in this field are the Bolivar Programme for Regional Technological Integration, Innovation and Industrial Competitiveness, and the Iberoeka Programme being carried out within the framework of the Science and Technology for Development (CYTED) Programme of the Spanish external cooperation system.

leads to the conclusion that the strategies outlined by ECLAC in 1992 for developing the capacity for the assimilation, adaptation and development of technology remain valid, especially as regards: i) strengthening social capacity for the absorption of knowledge by increasing the integration between technological and human resources development systems; ii) promoting firms' own research and development activities; iii) promoting cooperative research among firms and supporting the establishment of research and development consortia; and iv) encouraging stronger links between industry and research institutions.

Recent developments also suggest that these strategies must be supplemented by four additional elements: i) preventing technological lag due to the adjustment policies, since loss of local engineering capacity can give rise to permanent technological backwardness; ii) introducing policies on domestic competition which go beyond the liberalization of trade, since the small size of the market in most countries of the region would allow the few producers in the domestic market to prevent the entry of new suppliers or suppliers of substitutes, even for internationally tradeable products; iii) supporting the development of strategic alliances between large national firms and international technological leaders, as this is a key mechanism both for rapid technology transfer and for increased international linkages; and iv) acting in a way which takes account of the impact of current regional and subregional integration processes, especially as regards the coordination of technological policies and policies on intellectual property rights which reduce the scope for disseminating potential technology "spill-overs", a situation which could have serious repercussions on some production sectors.

Finally, three factors should be taken into account: i) the problems of technological policy in the region (like those of production development policy in general) are due much more to the failure to implement policies than to the absence of instruments to propose or policies to support; ii) the instruments applied and the institutions established have reflected a low level of commitment to technological change, leading to the development of institutions which have a positive effect on only a few enterprises and which channel only marginal resources; and iii) there are many businessmen in the region who do not even know that policies of technological modernization are in effect or who, if they do know this, very often write them off as inaccessible without first carrying out an in-depth evaluation.

Three sets of proposals are made below which emphasize the enterprise dimension and are particularly important for taking advantage of the technological know-how currently available and thereby closing more rapidly the great gap in factor productivity between the countries of the region and the developed countries.

The first proposal, which would permit a qualitative leap forward in this area, requires the initiation of programmes to speed up and generalize the dissemination of "best practice" technologies.

As was done during the reconstruction of Europe through the Marshall Plan technical assistance programme, it would be very useful to establish programmes for co-financing medium-length visits (between 6 and 8 weeks) to "best practice" plants abroad by businessmen, engineers, foremen and trade union leaders from the various local production sectors, who would later pass on what they had learnt to enterprises in their own countries. This idea is taken from a proposal by Carl Dahlman, a World Bank staff member, for the restructuring of the productive sector of the former Soviet Union on the basis of a report prepared for that institution (Silberman and Weiss, 1992). In the case of Europe, increases in productivity of between 25% and 50% were achieved at very low cost (some US$ 20 million per country at 1993 values to send between 20 and 40 people from each of 50 selected sectors) and with very little additional investment. Co-financing might mean, for example, that enterprises would continue

to pay the salaries of those of their workers who participate in the visits and prepare the corresponding reports, while the government contribution would finance the travel, subsistence and administrative costs of the programme. It should be noted that the gap between the total factor productivity of the developed countries and of Latin America (of the order of 2.5 to 1) is much greater than that existing between the United States and Europe in the late 1940s.

Because it would cost little and would lead to big productivity gains, such a programme could have a high cost/benefit ratio. Moreover, with the same multiplier as the Marshall Plan,[19] it would serve to disseminate experience to between 5,000 and 10,000 firms in each of the participating countries, making it possible for the region to take advantage of its late development and skip intermediate stages, thus moving more rapidly towards the global technological frontier.

This proposal has two additional advantages: i) it would increase national awareness of the importance of productivity, making productivity a national effort and not just the responsibility of firms or certain trade associations,[20] so that productivity would become a unifying issue by being presented as a national challenge and as the principal source of solid and lasting improvements in the standard of living of the entire population; and ii) it would be open to all sectors wishing to participate, or at least to the first ones each year which submit a programme for their sector and are prepared to participate in co-financing the programme.

In addition, this programme could be supplemented with another one successfully tried in Singapore, based on granting incentives to the first companies to introduce significantly new technologies in a particular category (both technologies that reduce costs and those that improve quality), since, in the last analysis, the first company to acquire a new and appropriate technology in its country is a "Schumpeterian innovator" that generates an externality: other companies can profit by its experience without incurring costs or risks of equal magnitude.

The second group of measures includes proposals which, taken individually, would not have a significant immediate impact but which, taken together, would have such an effect in the long run because they reinforce each other and have a cumulative effect:

i) Continuation of efforts to improve technological and management information systems and networks. Efficient systems with low-cost access for their users are an essential complement to efforts to modernize and heighten the awareness of enterprises. Moreover, it is essential to make progress in the development of an information infrastructure which makes possible the execution of ongoing sectoral studies to monitor the changes taking place on the international technological frontier. Permanent contact by regional producers with the available international information complements efforts to inform them of the experience of companies employing the "best practice".

ii) Improvement of the financing conditions for technological efforts. In most countries of the region, the funds handled by the institutions that are trying to promote technological development are insignificant compared with the total requirements of production modernization. Nevertheless, they can demonstrate to private banks the potential profitability of financing technological investment, and they can serve as a mechanism for learning and teaching how to evaluate technological risk. Conditions of financing should be revised to reflect support for the external economies deriving from technological development. To that

19 In the case of the Marshall Plan, each member of the mission transferred his experience to an average of between 5 and 10 plants in his country of origin.

20 Indeed, this was done in Europe during reconstruction, through the establishment of national productivity committees made up of heads of firms, trade unionists, technicians and public officials.

end, in spite of the difficulties involved, efforts should be made to evaluate the trade-offs between granting preferential interest rates and assuming all or part of the technological risk, as well as to move towards reducing the margin of intermediation for technological credit, the high level of which reduces demand from companies. It is likewise necessary to develop insurance for such credits and to strengthen the traditional mechanisms for financing prototypes and pilot plants, thus easing the firms' transition from pre-competitive research to the installation and start-up of production plants, with special attention to the needs and limitations of small and medium-sized enterprises.

iii) Dissemination of regional experience in the operation of institutions for supporting companies' technological activities. There is considerable experience in this field, but although it is well known to experts on technological questions it has not yet filtered through to decision-making bodies, particularly in small and medium-sized countries. Moreover, in spite of the positive experience accumulated in connection with technological centres at the level of industrial branches, incubators and technology parks, linkages between universities and enterprises and alternative financing mechanisms, the feasibility of expanding them to the whole economy has not yet been properly evaluated, yet without such expansion they will have only a marginal impact on productivity.

iv) Promotion of alliances among companies by simplifying procedures, providing information and granting fiscal incentives. The first two mechanisms are clearly called for if the aim is to promote a strategy of developing company alliances. Although there is no consensus on the third, it would undoubtedly serve to send a signal that this is a priority strategy for modernization and that, in view of its importance, there is a readiness to accept the necessary trade-offs in terms of public expenditure.

v) Support for the efforts of enterprises to modernize their associations. Many of the region's industrial business associations were established at a time when their basic function was to guarantee their members high levels of protection and good access to policy-makers and those responsible for public contracts. In the eyes of those they represented, the fundamental criterion used to measure the success of industry representatives was their efficiency in lobbying. In a new competitive environment characterized by trade liberalization and greater competition, however, such functions have lost some of their importance, and in some cases this has deprived some organizations of their very raison d'être. For that reason, the region's more modern business associations have sought to transform themselves into providers of services for their members, especially in areas related to the provision of information, the consolidation of efforts in the areas of trade and transport, and business and economic analysis. These efforts provide important externalities and should be supported as a mechanism which makes for higher levels of efficiency in the region. In particular, a mechanism which has shown itself to be especially useful for achieving such purposes is the facilitation of exchanges of modernization experiences among business leaders so that they can weigh alternatives and have access to the relevant advice.[21]

The third set of measures relates more specifically to the region's agriculture, as the special characteristics of this sector require that special attention be paid to the forces which can promote technological change in it. Thus, the small average size of farms, producers' difficulties in organizing themselves to carry out and internalize technological efforts, the need to adapt even basic techniques to specific soil

21 A successful example of such exchanges in the region is the modernization effort made by the Chamber of Industry of the State of Carabobo (CIEC) and the Venezuelan Plastic Industries Association (AVIPLA). For an analysis of these efforts, see León (1993).

and climate conditions, and the difficulty of protecting intellectual property rights in this field call for a special effort by the public sector.

In order to achieve more dynamic growth in which the agricultural sector plays an important part, it is necessary to restore and promote public programmes of technological research and dissemination. With the crisis of the 1980s and the consequent reduction in public expenditure, agricultural research and extension systems suffered contraction and dismantling which resulted in significant deterioration in the capacity to generate and disseminate agricultural technologies, precisely in a sector in which such linkages had been most successful. The full impact of these cutbacks has yet to be felt, given the long delay between theoretical research, its experimental development and its subsequent dissemination and full maturity.

Resuming the unfinished research and restoring research teams will require a long and considerable effort, but this is all the more necessary because the region needs the expansion, diversification and development of "non-traditional" crops (ECLAC, 1993d). This is particularly important because perfecting a new variety requires a decade or more of research and adaptation: a period of time which increases considerably in the case of the genetic improvement of animals. In an environment of highly dynamic markets, in which agricultural and agroindustrial products appear and are replaced with great rapidity, research and dissemination in the field of agricultural technological innovation is a decisive factor for ensuring a supply capable of adapting to the quality and timing requirements of such markets. This is even more evident in the case of products or crops that are new to a country, in which case the adaptation process and the introduction of quality standards must be carried out in the shortest possible time.

Some countries of the region have become aware of this situation and its requirements and have taken action in recent years to restructure their national systems of scientific and technological research. The importance of these measures should be emphasized, as recent studies on the social profitability of agricultural research and extension have shown highly favourable results. Indeed, one of them, which aggregated the findings of 114 specific studies on the subject in developed and developing countries, concluded that the rate of social profitability of investments in this area was above 50% in 45% of the cases, between 30% and 50% in 42% of the cases, and below 20% in only the remaining 13% (Evenson, 1992).[22]

Lastly, mention must be made of the considerable impact that proper linkages between producers and agroindustries can have on the modernization of the agricultural system, especially in the case of small and medium-scale producers. The fact that agroindustrial enterprises need inputs of a given quality, at a given time and with high yields (to avoid high transport costs) leads them to provide technical and financial assistance to agricultural producers, and this is an important means of transferring technological advances and improvements (see box VIII.2).

2. Training policies

Education and training are basic determinants of the competitiveness of countries. There is no doubt that the basic require-

22 Similar results were obtained with regard to investments in agricultural extension systems. In this connection, it should be emphasized that, even when extension services are not very efficient, the externalities generated are considerable and directly benefit the rural community in areas such as adult education and training and improvement of communications. Moreover, the results obtained were not significantly different for developed and developing countries. This makes it clear that there are very good reasons for investing in national systems of agricultural technology generation and dissemination.

Box VIII.2

LINKAGES BETWEEN AGRICULTURAL UNITS AND AGROINDUSTRY

Research carried out by the Agricultural Development Unit of ECLAC and by country institutions has made clear the effect of agroindustrial processes on the productivity and product quality of agricultural activities. In certain circumstances, agroindustry constitutes a powerful means for modernizing agriculture, particularly in the case of small and medium-scale producers. This phenomenon is particularly important in some agroindustrial chains usually, although not exclusively, connected with foreign markets. The need to ensure good quality and an adequate supply of raw materials leads many agroindustrial enterprises to sign contracts involving the provision of technical and financial assistance to farmers, who, in turn, must meet pre-established standards and deliver their products on schedule. For some products such as vegetables, where quality depends to a large extent on careful handling, agroindustries prefer to establish relations with family farms, usually small-scale ones. In many of these cases, the technology transferred has more general applications and can be used for other crops too.

There is much evidence that an environment of stable, long-term contractual relations has led to increases in productivity and that in the course of time productivity levels even out between the various scales of producers. Examples of this are to be found in activities such as milk and sugar beet production and tobacco growing. Moreover, the share of contract agriculture covers a significant portion of the total. Research carried out by ECLAC in Paraguay shows that of a total of 307,000 producers, nearly 200,000 have some form of contractual relationship with agroindustry. Of these, nearly 130,000 are small farmers with less than 10 hectares of land. In most cases, these contracts provide for advance payments in cash and in kind. These arrangements by agroindustries for financing agricultural producers are additional to those provided by Paraguay's National Development Bank, which covers almost 30% of the land under cultivation.

In Chile, of a total of 200,000 production units, about 80,000 producers have linked themselves with agroindustry. Of these, more than 60,000 are small farmers and, in most cases, are dependent on the corresponding agroindustrial chain and receive technical and financial assistance. In industrial crops such as tobacco, sugar beet and tomatoes for paste and concentrates, this assistance may cover 100% of producers. Similar rates of coverage are also found in the case of new export products such as berries. This phenomenon is not limited to exports, however. In the dairy products chain, which is basically geared to the domestic market, technical and financial assistance for producers is also widely prevalent as a means of raising productivity and the quality of the raw material.

Another study, carried out by the Bank of Guatemala in 1990, shows that about 80% of agricultural producers specializing in fruit and vegetables for export are linked to agroindustrial enterprises by various contractual agreements under which nearly 75% of them normally receive technical assistance. This has made it possible to increase and standardize productivity for a large number of export crops.

Source: ECLAC, Agricultural Development Unit, on the basis of case studies for various countries.

ment for securing a lasting, long-term improvement in the productive competitiveness of the region and the standard of living of its population is educational reform focused on quality. Nevertheless, in the short term, training is the activity most closely related to the competitiveness of the production sector and the main instrument for equipping the workforce to cope with labour-related changes in the enterprise. This is all the more necessary now that rapid changes in technology, the organization of work and demand make it essential for the workforce to be able to learn on an ongoing basis.

a) The problem, the potential and the challenge

The few studies available on the training activities of enterprises in the region show that they are of rather modest proportions, with no more than 10% of em-

ployees receiving any form of training. This contrasts with the evidence that training costs have a high rate of social profitability (25% on average, and always more than 10%), as indicated by evaluations of vocational training programmes which include apprenticeship, initiation and supplementary training courses (ECLAC/OREALC, 1992). Moreover, the average worker in the region currently receives barely a month of training throughout his working life, which contrasts with the 5 - 10 months of training he would receive if 1% of the payroll were devoted to this purpose, in line with the internationally suggested minimum and the legislation of various countries of the region.[23]

Not only is there little training, but the management of human resources in the region is frequently not of a professional nature and does not follow integrated programmes, being dictated instead by short-term considerations. In this context, training is seen as a mass of dispersed efforts, in response to specific requests or problems, without reference to the overall production process. Businessmen generally regard training as a cost rather than an investment, and therefore naturally tend to minimize it. They frequently regard it as a social benefit granted to employees and rarely connect it with the firm's modernization strategy. This is in line with their perception that external factors (especially exchange rate policy, foreign trade legislation and tax policy) are much more important for their competitiveness than factors internal to the enterprise (ECLAC, 1988a and 1993e; Guerguil, Macario and Peres, 1993).

A clear and very up-to-the-moment example of the secondary role which many enterprises assign to training is the way in which computerized equipment has been introduced: despite its importance, it has been accompanied by only a minimum of training, and this has, of course, reduced the possibility of improving the productive efficiency of firms. On the one hand, there is no question that computerized machines are more productive, facilitate quality control and are generally easier to use, as a result of which they require less initial training.[24] On the other hand, such equipment requires sophisticated maintenance services which are usually contracted outside the firm, generally from the supplier himself. The lack of training of the firm's maintenance staff prevents them from coping adequately with the tasks of basic maintenance, the adjustment of machines or the detection of malfunctions. In countries where the external supply of maintenance services is not very efficient, down-time is lengthened and there may even be reluctance to introduce new machinery because entrepreneurs see it as involving greater risks of interrupting the production process.

Moreover, many of the enterprises which have introduced computerized machines fail to take advantage of their versatility, because of the scant training they give its operators, who are then unable to control the efficiency of the process or the quality of the product, necessitating a

23 Part of the reason for the minimal training given to workers, even where programmes with significant financing exist, is that generally such training is directed towards only a few workers and enterprises, and many of the "workers" who receive it are middle or senior-level managers. External training (outside the enterprise) in fact usually concentrates on administrative or management subjects, instead of those directly related to production. In Chile, for example, almost half the staff trained in 1992 belonged to the management and administrative categories (SENCE, 1993). In contrast, the training of production staff is usually carried out in the enterprise, with inside instructors; such courses are usually narrow in scope, covering only initial training (for a specific job) or training related to the introduction of new machinery; the former is usually provided by supervisors and the latter by suppliers.

24 This technology transfers part of the workers' skills in production programming to the machine's computerized memory, which can then perform very complex routines without interruption.

greater number of final checks, and unable to adapt themselves quickly to changes in product specifications. By contrast, enterprises which have made greater training efforts achieve higher product quality and, in general, greater productive efficiency.[25]

The contrast between the minimal training provided and its high social profitability naturally raises the question as to why this discrepancy between possibility and reality exists. Basically, the answer would be that entrepreneurs see (general) training as benefiting the worker, not the enterprise, because worker productivity is increased not only in the enterprise in question but overall, so that the enterprise must pay the whole cost of this greater productivity but cannot recover the cost of (general) training. On the other hand, the main beneficiary of the potential training —the worker— usually lacks the resources needed to finance it (both the direct and the opportunity costs).

In the light of these factors, three complementary approaches seem possible: i) to recognize the primary interest of the worker in his own training and generate instruments in the capital market which will make it possible to use new forms of financing for people who wish to receive advanced training, using, for example, their pension fund or social security accounts as a guarantee; ii) to develop training activities with the help of State resources: an approach which is fully justified because such activities are a public asset and generate considerable externalities; and iii) to seek to change entrepreneurs' perceptions about training, promoting a broader and longer-term outlook. As the first point has been analysed in detail in ECLAC (1992a), proposals will be developed in this document which go more extensively into the other two.

b) Proposed measures

Three kinds of measures are proposed for reducing the gap between the potential and actual productivity of the workforce as quickly as possible.

i) *Measures to stimulate and channel the demand by enterprises for training services through the provision of training for heads of enterprises and differentiated incentives*

a. *Direct or indirect incentives for training.* In some countries of the region, there are financial incentives for training, either positive (tax exemption) or negative (deduction of the cost of activities carried out in enterprises themselves from the compulsory contribution to vocational training institutions).[26] Although these mechanisms do not seem to have attracted new resources quickly and massively to training, as only a few enterprises (especially the large ones, which usually train their personnel in any case) take advantage of them,[27] these incentives have nevertheless had other positive effects, such as promoting expansion of the private supply of training services, providing more information on these services and furthering greater market transparency. Moreover, they may have positive side-effects if they are accompanied by promotion and

25 In a survey of firms in the garment industry, a clear inverse relationship emerged between the length of initial training and the rate of final defects (Guerguil, Macario and Peres, 1993).

26 Most countries in Latin America and the Caribbean have introduced a compulsory tax, equivalent to 1%-2% of the firm's payroll, for financing public or semi-public vocational training institutions. Some countries (Brazil and Venezuela, for example) authorize firms that carry out their own training activities to deduct all or part of the cost from that tax payment, while some other countries (Chile is the most obvious case in the region, but Argentina and Brazil have similar, albeit less extensive schemes) allow firms to deduct training costs from the taxes due on their profits (Ducci, 1990).

27 In Chile, for example, in 1992 only 6% of the total number of firms made use of the tax exemption for training; although enterprises with more than 200 workers accounted for only 17% of these firms, they received almost 80% of the value of the subsidies granted (SENCE, 1993). Similarly, in Brazil, only 7% of enterprises opted in 1987 to reduce their compulsory contribution on the grounds of their direct training activities (ECLAC/OREALC, 1992; Ducci, 1990).

information efforts on the part of the authorities.[28] It would therefore be useful to introduce mechanisms of this kind in appropriate countries.

The possibility of reducing, at least partially, the compulsory contribution by enterprises to vocational training institutes, on the basis of the training activities carried out by the enterprise itself, is a particularly efficient mechanism for simultaneously promoting both the supply of and the demand for training. One possible form of action would be to establish a training fund which would grant subsidies on the basis of the amount which firms spent on training; in this case, the burden of financing could be shared between the public and private sectors, with public funds acting as the counterpart of the private contribution or providing the necessary seed capital, which would then be replaced by private resources.

It would also be advisable for public subsidies to be differentiated on the basis of the expected social effectiveness of training activities. For example, more general training (rather than the specific training that the enterprise would in any case carry out) and the training of staff with a lower educational level should be subsidized more heavily. Other programmes which should be given greater incentives are those which envisage training that is passed on down to lower levels, including the training of staff to act as "potential instructors" who will then responsible for passing on within the enterprise or plant the knowledge they have acquired. In addition, in order to reinforce the impact of financial incentives and subsidies, in special cases direct incentives might be considered, such as the creation of an ad hoc committee to promote training in enterprises, which would be responsible for identifying enterprises where there is room for improvement in this field and helping them to establish and implement internal training programmes.

b. *Promotional, information and awareness-building measures.* In order to speed up the dissemination among employers of more efficient practices in the fields of labour organization and human resources management, it is proposed that dissemination and information activities on these issues be carried out with a view to changing prevailing attitudes. Consideration might be given, for example, to the establishment of an "open school" for businessmen, with seminars in various cities, lectures by specialists, case illustrations, plant visits, etc.[29] Moreover, encouragement could be given to the establishment of centres which provide information and advice on the availability of courses, teaching materials, training techniques, etc. Since lack of training is not usually the only impediment to a firm's competitiveness, such centres might offer complementary services such as technological information, market studies, management techniques, and industrial extension services in general, in order to increase their attractiveness to the business world.

Conflictive labour relations limit both the desire of enterprises to train their employees and the desire of workers to take part in the corresponding programmes. An environment of mistrust and conflict leads the owner of an enterprise to limit training to what is strictly necessary to ensure the operation of the equipment, since he is afraid that better training for the workers will translate immediately into pressures for wage increases. The workers, for their part —since they do not feel involved in the fortunes of the enterprise— tend to see training simply as a means for the owner to increase productivity without giving them anything in return. It is common, in such cases, for the

28 In Chile, for example, a growing number of enterprises have been making use of the system of tax exemption for training activities; the increase in the share of small enterprises in this total is particularly important: from 24% in 1978 to 58% in 1992 (SENCE, 1993).

29 As we saw in the section on technological policies, among the measures which might be considered are visits to foreign plants using the best international practice.

attitude of workers to training courses to be one of apathy.

Finding ways of promoting better labour relations within the firm is therefore a necessary step for encouraging a favourable attitude towards training on the part of both the trade unions and businessmen. The holding of seminars on this subject directed jointly at businessmen and trade union leaders, the dissemination of experiences in which good labour relations have played an important part in improving the productive performance of specific firms, and increasing support for better training on the part of trade union leaders are measures which can help to promote relations directed towards cooperation rather than conflict within an enterprise, thus creating a more propitious climate for increased training efforts and greater benefits from them.

ii) *Expanding the supply of training services and improving their quality*

The regional supply of training services is limited and comes, for the most part, from public or semi-public institutions financed by firms' compulsory contributions. At present, much of the activity of these institutions is geared to the initial training of young people for traditional occupations or to social fields such as rural training, assistance to small businesses, and training of traditionally neglected groups such as marginal urban workers and the self-employed. Moreover, with some exceptions, these institutions have proved to have only limited capacity for adapting to the demands of the modern production sector and their programmes have gradually become obsolescent; consequently, the services they offer attract little interest from enterprises. Public expenditure on such institutions accounted for somewhat less than 0.5% of GDP during the 1970s, but it decreased in the 1980s as public resources became more scarce and enrolment declined: in 1987, enrolment was estimated at only 2% of the region's labour force (ECLAC/OREALC, 1992; Ducci, 1990).

The private supply of training services is even smaller and comes basically from suppliers of machinery. In addition, there are a number of consulting institutions which provide training services generally directed at administrators and managers, the supply of which has increased significantly in recent years. Lastly, there are a few training centres belonging to large enterprises or groups of enterprises which use them for the initial training and later upgrading of their employees.[30] The main feature of the training market in the region is therefore its lack of development and its distribution between relatively obsolete public institutions and a handful of private institutions. It is up to the authorities to design policies which will make it possible both to broaden the scope and improve the quality of this supply, to which end four lines of action are needed:

a. *Institutional development*. The promotion of such development involves abandoning the traditional methods, which give priority to the supply of these services by the public sector, in favour of another approach which seeks to concentrate public action in the areas where it is most needed (especially the training of traditionally neglected sectors such as own-account workers or workers in the informal urban sector), while at the same time encouraging private supply, which is more flexible and more closely linked to the needs of enterprises. This change of focus requires the establishment of new norms for the provision of training services and the regulation of the market. Some countries, for example, establish public monopolies for the supply of some services of this kind; others restrict or even prohibit apprenticeship contracts. These restrictions should be eliminated in line with the new requirements of the industrial and labour sectors. As a complementary measure, adequate channels for the

30 In Chile, the country in which the private supply is relatively most developed because of the impact of the existing tax incentives, there are no more than 520 of these institutions in the entire country (one for every 900 enterprises).

dissemination of information should be created, such as centres or networks for exchanges between enterprises, so that firms can share information on such services and their evaluation. As the training market develops, support can be given to the establishment of mechanisms for certifying the training given. For such certification to make an effective contribution to increased competitiveness without hindering the flexibility needed to meet the changing needs of the productive environment, it is necessary to have the active participation of business and trade union associations.

b. *Improving the quality of the supply of public training services.* Although there are examples of public institutions in the region which carry out training tasks, in many cases it is essential to make their operations more flexible so as to bring them closer to enterprises and make them better able to meet the latter's needs. Some of these public institutions, for example, have already replaced long-term formal education by short in-plant courses; others have signed agreements with enterprises to provide training services better adapted to the enterprise's needs. In general, it would be desirable for these public institutions to develop two-pronged training procedures which would increase their links with enterprises and facilitate their graduates' subsequent access to the labour market. Encouragement should also be given to the provision of such services by other educational institutions, such as technical institutes and universities, which would then be able to improve their curriculum by gaining a better understanding of the problems of enterprises and supplementing the training they give with in-service training of their students in production plants.

c. *Making full use of training sources outside the enterprise*, such as suppliers of machinery and equipment, professional journals, visits to plants or the services of expatriates from the region who are performing highly skilled jobs in developed countries and can transfer their expertise during brief visits to their countries of origin.

d. *Promoting the development of purely private training facilities.* Three kinds of measures might be particularly useful for this purpose:

i. In addition to the financial incentives to demand already referred to, incentives can be offered to encourage enterprises which have their own training centres to share them with other enterprises in the same sector, particularly their suppliers or subcontractors. This would give smaller enterprises access to training and strengthen coordination linkages between enterprises by making use of subcontracting networks as collective education mechanisms.

ii. Public training programmes, such as those directed towards marginal or neglected sectors, should consider inviting competitive bids for the provision of at least some of the services they offer.

iii. Consideration could be given to public support for the retraining of instructors and the modernization of the equipment of private training institutions, as there is often a significant gap in terms of modernity between their equipment and that of enterprises; this reduces the relevance of the training given and leads to concentration within the overall supply of training on administrative and sales areas, where the investment in equipment is much lower. To achieve this goal, tax legislation could be revised to encourage contributions from firms in the form of loans of equipment and materials and in-service training of instructors. An additional option would be to include private training institutes in public programmes of technological support.

iii) *The main prerequisite: improving the general educational level of the present and future labour force*

It must be emphasized, once again, that any significant and lasting improvement in the competitiveness and standard of living of the region is dependent on reform of the educational system aimed at improving its quality. A joint ECLAC/UNESCO document prepared in 1992 (see box VIII.3, which summarizes the document) notes that although the educational, training and science and technology systems of most countries of the region have expanded considerably in recent decades, they have obvious deficiencies as regards the quality of their results and the possibility of equal access to them by all levels of society.

Successful as they may be, educational reforms will only begin to have an effect on the labour force 15 or 20 years from now

Box VIII.3

THE JOINT ECLAC/UNESCO PROPOSAL FOR REFORMING HUMAN RESOURCES TRAINING SYSTEMS IN THE REGION

This proposal, made in 1992, notes that a quality educational system requires institutional reforms which will transform it into a participatory, flexible, open system integrated into its environment and helping to encourage the relevance and mutual enrichment of educational, training and research and development systems and of the production and social systems. The strategy proposes the adoption of new standards of equity, emphasizing real equality of opportunity and giving priority to the effectiveness and quality of educational practices and their results, allocating the best resources to the places of greatest need, and getting away from the traditional emphasis on quantitative indicators.

On this basis, policy measures in seven areas are identified. The first concerns institutional reform of the system of production and dissemination of knowledge, along two basic lines: i) a decentralized form of organization designed to increase the autonomy of educational establishments and thereby their flexibility in adapting to the changing needs of the environment in which they operate; and ii) a flexible regulatory framework that ensures the integration and coherence of the system, equitable access and certain minimum levels of efficiency by strengthening the governing bodies and establishing systems of accreditation and certification.

The next two areas relate to the results sought by this institutional liberalization. First, emphasis is placed on the importance of ensuring universal access by the population to the set of skills and knowledge which they need in order to participate in public life and function productively in modern society. Such skills are the necessary basis for future learning in or out of school. One essential requisite for achieving universal access to them is to guarantee universal basic educational coverage, but it is just as vital, or even more so, to improve the *quality* of education. Second, international experience has shown that competitiveness is positively related to policies which promote innovation and dissemination of scientific and technological progress. In this respect, actions are proposed to increase the supply of technology, the demand for it from the production system and the linkages between the two.

The last four policy areas are of an instrumental nature. The best way to ensure the internal and external efficiency of a decentralized system is to establish an effective system of information and evaluation, since this enables users to demand higher quality, helps schools to improve their performance, and makes it easier for the authorities to concentrate their action where results are poorest and the equity of the system most needs strengthening. Emphasis is also placed on the urgent need to raise the professional level of teaching, through reform of the processes of recruitment, training and remuneration of teachers. Financing policies are then outlined to help bring together various sources of public and private funding, with selective mechanisms for allocating public resources in line with the objectives of increasing competitiveness and equity. Lastly, various areas of potential international and regional cooperation are identified.

Source: ECLAC/UNESCO Regional Office for Education in Latin America and the Caribbean (OREALC), *Education and Knowledge: Basic Pillars of Changing Production Patterns with Social Equity* (LC/G.1702/Rev.2-P), Santiago, Chile, April 1992. United Nations publication, Sales No. E.92.II.G.6.

and will not solve the immediate problem of the inadequate basic education of almost half the present workforce of the region (see box VIII.4 on the educational level of the region's labour force). The fact that these workers do not have the minimum reading, writing and arithmetical skills needed in order to respond efficiently to the requirements of a modern production system that is increasingly integrated into the international economy reduces labour productivity and, ultimately, business competitiveness and increases the amount which firms must spend on initial training.

The above assertion is corroborated by the real situation of enterprises, according to the results of a survey of firms in the garment industry carried out in 1993 in some countries of the region. These results show that Mexican firms require an average of six weeks to train a newly hired machinist, as compared with only two weeks for Chilean firms; in other words, in order to make up for the lower average educational level of the population (six years in Mexico as compared with nine years in Chile), Mexican firms must spend three times more than Chilean firms on initial training, quite apart from the impact of the other factors that affect the amount that must be spent on initial training, such as the rate of staff turnover and wage levels (Fluerguil, Macario and Peres, 1993).

In order to ensure that this large number of workers with incomplete primary education ceases to be a short-term obstacle to the productive modernization of the region, it is necessary to:

a. Increase general education opportunities for the adult population and make their access to such services more flexible. This calls for efforts to promote an awareness that such educational efforts are of benefit to both the enterprise and the worker and, where necessary, the amendment of labour legislation to authorize the granting of unpaid leave for this purpose.

b. Incorporate basic education subjects, such as mathematics or writing skills, into the training activities of firms or suppliers of machinery. Although some firms have already found it necessary to carry out such activities, it is very unlikely that the practice will become widespread, because of the likelihood that the trained worker will leave the firm. To overcome this reluctance, it is suggested that tax incentives be offered to firms which incorporate general educational subjects into their training programmes. The authorities should also promote the design of teaching materials and their dissemination in business circles.

It must nevertheless be clearly understood that training is not a panacea for problems of low labour productivity. Even with the efforts suggested, investment in training cannot compensate completely for deficiencies in the basic education of the workforce. Moreover, in order to make training more fruitful and make investing in it attractive, it is necessary to introduce substantial changes in the management styles prevailing in many firms in the region, where centralized management leaving little room for workers to contribute actively to an increase in productive efficiency still predominates.[31] In these circumstances, it is understandable that owners of firms may fail to see training as a fundamental tool for increasing productivity.

Breaking this vicious circle, in which deficient management of the firm and mutual distrust between the workers and their employers act as disincentives to training and ultimately undermine labour relations, is the primary goal of the proposals made in this section.

31 Firms that are successful at the global level usually have management styles which stimulate by various means active participation by workers in decisions relating to production processes. When they assume greater responsibilities, workers increase their commitment to the goals of the firm, and this is reflected in suggestions for innovations which can have positive effects on production and organizational procedures. In these enterprises, improving the skills of the workforce becomes a highly profitable investment.

Box VIII.4

EDUCATIONAL LEVEL OF THE REGION'S LABOUR FORCE

Because of the considerable expansion of educational systems in the last 30 years, Latin America's economically active population now has an average of six years of schooling, but the impact of these quantitative advances has been sharply reduced by the low efficiency and high rates of repetition prevailing in basic education. The decrease in the proportion of the population without any education has probably been accompanied by an increase in the proportion whose primary education is incomplete, with a much smaller increase in the proportion with post-primary education. It is estimated that, at the beginning of the 1990s, at least 70 million people (40% of the economically active population of the region) have not completed their primary education and could be considered absolutely or functionally illiterate, while only 30% (slightly more than 50 million) have had some post-primary education.

The above data do not bear comparison with newly industrializing economies (NIEs) such as the Republic of Korea, where even in 1980 only 16% of the EAP had an educational level below that of primary schooling. Moreover, the present figure for Latin America is higher than that for the South-East Asian countries as a whole (including relatively poor nations like the Philippines and Thailand), where the figure for workers without full primary education was 37% almost a decade and a half ago (1980).

It is estimated that the working-age population (WAP) of the region will exceed 350 million by the year 2000. Since the population now of school age will only represent a little more than a quarter of that total, even a rapid and spectacular increase in the coverage and quality of primary education in the current decade will have only a modest influence on the educational level of the WAP as a whole. For example, an increase of two years in the average educational level of the population leaving school during the 1990s would only result in an increase of 0.5 years in the average educational level of the WAP. Improvement of the *quality* of basic education would have a more visible, though still modest, effect: thus, if 80% of each age group completed primary education (as compared with only 60% at present), the proportion of the WAP without education or with incomplete primary education would still be over one-third of the total in the year 2000.

Source: ECLAC/UNESCO Regional Office for Education in Latin America and the Caribbean (OREALC), *Education and Knowledge. Basic Pillars of Changing Production Patterns with Social Equity* (LC/G.1702/Rev.2-P), Santiago, Chile, April 1992. United Nations publication, Sales No. E.92.II.G.6.

3. Infrastructure development policies

It has been repeatedly stressed throughout this document that competition in foreign markets is not something that takes place simply among isolated companies. When companies compete, they are supported by an infrastructure in which the functioning of the energy supply, telecommunications, transport networks, ports and customs plays a prime role. The legal and institutional framework, the efficiency of the banking system and the prevailing business culture are also basic infrastructural elements. The concept of systemic competitiveness assumes special importance when it is understood how important it is for firms to be able to rely on an infrastructure that is equal to the challenges they have to face.

A survey based on interviews with businessmen in several countries of the region showed that manufacturing firms which export from countries where such support systems function reasonably well have a substantial competitive edge (Guerguil, Macario and Peres, 1993). On the other hand, there are countries where the difficulties encountered by firms when they try to send their merchandise abroad and therefore have to go through customs are so serious that they are one of the main reasons why companies do not even try to export. Complicated customs procedures, corruption and the risk of theft are such

formidable obstacles that beginners in the export business finally give up trying to overcome them. In other countries, deficient telecommunications and energy supply systems raise costs considerably because firms are forced to establish their own facilities for such services.

These differences are serious enough to alter the competitive conditions of businesses with otherwise similar productivity characteristics. Thus, for example, in two countries of the region of very different sizes, a survey was made of two companies which were similar as regards their products, size and quality levels and which had both made significant efforts to improve their internal organization and raise their productivity. However, the products of the company in the larger country faced competition in their own market from the products of the company in the smaller one. This difference in competitiveness did not originate in the companies themselves, but in the environment in which they operated. While the company in the smaller country operated within an environment which was relatively efficient for its needs, that in the larger country had to contend with arbitrary import and export formalities and absorb the costs of an inefficient transport system, customs delays and the large number of permits needed in order to operate. All this resulted in higher production costs which eventually cancelled out the initial similarities in physical productivity.

a) Energy supply

In some countries of the region, a stable energy supply is a priority target for enhancing companies' competitiveness. One of the prior conditions that must be met if a manufacturing firm is to be able to produce efficiently and if its products are to be competitive in international markets is that it should have an adequate, steady energy supply at reasonable cost. The long period of time needed for the installation and start-up of an adequate energy generation and distribution system clearly shows the systemic nature and public utility of such a system, as well as the various externalities it generates along the production chain.

In countries with an inadequate energy supply, a common complaint from businessmen is that the introduction of relatively sophisticated equipment results in energy shortages for the rest of their company's production processes. Moreover, energy supply restrictions are also an obstacle to plant modernization and the use of new technologies, as well as presenting a major challenge to regional integration efforts (see box VIII.5).

b) Telecommunications

Properly functioning telecommunications are important for any productive activity, but they are absolutely crucial when a company is trying to penetrate export markets.

When companies have problems in communicating with their customers abroad or in receiving their orders, this often results in loss of markets even for products which are competitive at the international level or for companies which exploit rich, high-grade natural resources. Such problems usually force companies to spend large sums of money on acquiring a telecommunications system which operates properly. For example, Venezuelan businessmen have expressed their dissatisfaction with the inefficiency prevailing in telecommunication services there, despite rate increases in recent years which they would not mind paying if the services were satisfactory.

A detailed survey conducted in several countries, inside and outside Latin America, showed a positive correlation between increases in telephone density and average investments in telecommunications, on the one hand, and indicators of competitiveness on the other (ECLAC, 1992a). According to the survey, telephone density is much lower in the countries of the region than in some countries in other areas where GDP has grown faster. This is especially true for the Republic of Korea, which at the end of the 1980s had a much higher telephone density indicator than the Latin American countries, although it

Box VIII.5

MODERNIZATION AND RATIONALIZATION OF ELECTRIC POWER SERVICES IN CENTRAL AMERICA AND THE CARIBBEAN

In the Dominican Republic, the Dominican Electricity Corporation (CDE) held a monopoly over electric power generation until 1990. While the company had a total installed generating capacity of 1,140 MW in that year, plant obsolescence and lack of maintenance, as well as inadequate price-fixing and revenue collection policies, prevented it from generating more than 590 MW. Because of these problems, the electric power supply was sometimes interrupted for more than 12 hours a day.

Electric power supply difficulties were a major problem for Dominican manufacturing companies, which were often compelled to install their own generating plants at an extremely high cost, both for individual companies and for the economy as a whole. In 1988, for example, the cost of power cuts in terms of loss of production was estimated at US$ 180 million, the equivalent of 3.3% of that year's GDP. CDE is currently engaged in a process of administrative restructuring and is making new investments with the support of the World Bank, in order to correct these problems and regularize energy supply.

The State electric power companies of all the Central American countries and Panama are currently looking into ways of linking up their national electric power systems. Such linkages would enable these countries to obtain electricity from a neighbouring country in the event of failure of their own supply, as has happened in the case of Argentina, Brazil and Paraguay, which share the hydroelectric power grid based on the Itaipú Dam. The project for Central America would cost US$ 500 million and would be financed by the Inter-American Development Bank and the Governments of Spain and China.

Source: M. Peña, *Privatización de la Compañía Dominicana de Electricidad* (CDE), Santo Domingo, 1991, and World Bank, *Dominican Republic: Issues and Options in the Energy Sector*, Report No. 8234-DO, Washington, D.C., 1991.

had begun the decade with similar indicators. The survey in question concludes that it is imperative to establish an adequate telecommunications infrastructure and to encourage the broadest possible dissemination of information technologies in order to stimulate productivity increases in individual companies. Once again, the fact that these services are in the nature of a public good providing strong externalities clearly stands out, and that is precisely why the formulation of an adequate regulatory framework is needed when such services are privatized.

Likewise, it is essential to improve the telecommunications systems that support computer use, and especially electronic data exchange, at both the national and international levels. The strong shift in the region towards export-led growth makes it increasingly necessary to modernize these support systems for business management, which involves not only timely, informed decision-making but also new management techniques such as "just in time" delivery of materials and global sourcing, both of which depend on a continuous flow of "real time" data.

c) Cargo transportation

In recent years, cargo transport needs have grown sharply in the region, in terms both of frequency and of the average volume of shipments. At the same time, there have been changes in methods of transportation all over the world, and a growing proportion of cargo is being containerized. All these changes require large-scale port and road infrastructures, which likewise assume the character of public goods producing important externalities.

In most countries, the cargo transport infrastructure takes the form of links between major cities and the sources that supply domestic markets. Patterns developed in colonial times, when roads were built between ports and mining or agricultural areas, also persist. These ports, in turn, were designed chiefly for

exporting traditional commodities and their installations are not always suitable for handling some of the new products which are emerging as a result of the diversification of the region's economies.

In Venezuela, for example, a survey of 40 companies which together represent about 43% of non-traditional exports revealed that low competitiveness was due mainly to transport problems (Clemente, 1993). Similar observations are often made about Mexico's inefficient road transport system, which accounts for 75% of cargo traffic. Likewise, 45% of the companies surveyed in a study on the competitiveness of Brazilian industry were of the opinion that it was necessary to modernize the transport infrastructure, including roads, railways and port operations (MCT/FINEP/PADCT, 1993).

The inadequacy of the highway infrastructure of certain countries of the region results in traffic congestion problems, particularly in cities and near ports. Roads also deteriorate because they were designed years ago for trucks and buses that were smaller and lighter than those used today, and this deterioration is further accelerated by truck overloading made possible by inadequate or non-existent provisions for regulation and inspection.

As in other infrastructural areas, the region is still recovering from the drop in tax revenues earmarked for transport infrastructure in the 1980s. This reduction resulted in a lack of new investments, but its repercussions were even greater on the existing infrastructure, which suffered severe deterioration as a result of lack of maintenance. The resulting deficiencies continue to prevent the transport system from adequately meeting the demands made on it. In order to reverse this situation and ensure the rehabilitation and proper maintenance of the road system, several countries are awarding concessions to the private sector, where this is economically viable, in order to lighten the burden of this branch of the infrastructure on the public budget.

The discrepancies existing between countries or groups of countries with respect to the standards regulating truck weight and size represent an additional problem for international transport. In rail transport, there are gauge (track width) incompatibility problems at border crossings where the rail systems of Brazil and Uruguay, Guatemala and Mexico, and Brazil and Argentina meet, thus limiting the contribution that this means of tansport could make to efficient international trade.

Some efforts can be made at the enterprise level, however, to use the existing transport infrastructure more efficiently. One option is to promote the consolidation of cargo among groups of companies in order to reduce transportation costs. In more general terms, it is essential to establish the legal and institutional frameworks needed to reap the considerable benefits of multimodal transport. These transport systems must not be geared only to the domestic market or to the export of traditional commodities, but must encourage competitiveness throughout the foreign trade sector.

Lastly, in addition to increasing investments in infrastructure, priority must be given to its efficient management. This involves implementing adequate toll policies, which are a prerequisite not only for achieving greater efficiency but also for ensuring the sustainability of infrastructural investments over the long term (Winston, 1991).

d) Ports

Port management, port charges and loading and unloading facilities affect the final cost of exported goods and also compliance with delivery dates, all of which are clearly important for maintaining positions won in foreign markets.

Efficient port management requires reforms which involve the modification of labour, institutional and physical infrastructure variables. Labour reform means putting an end to the monopoly of cargo handling by dockers' unions as well as union workrolls which favour their own members. Institutional reform requires the establishment of a legislative framework

which identifies and defines the rules for private sector participation in loading and unloading ships and in financing port investments. It is interesting to note that the market is already headed in this direction with the vertical integration of big national groups which are extending their operations from natural resources to transportation and finally also to port infrastructure, as is clearly seen in the production and marketing of soybeans and sunflower products in Argentina.

An example of the achievements which such changes can bring about is the case of Chile, where the 1981 port reforms enabled operations to increase from one and a half shifts approximately 300 days a year to three shifts 365 days of the year. This made possible not only the reduction of port operating costs, but also the postponement for ten years of fixed investment in port expansion which would otherwise have been necessary. In the case of fruit exports, it reduced the unit handling cost per crate from US$ 0.54 to US$ 0.26 and the turnaround time for ships from 129 to 40 hours. It has been estimated that these port reforms permitted savings of US$ 75 million a year (ECLAC, 1990a).

One case which is all too typical in the region is the situation in Mexican ports, where the problem has been so severe that companies located in Monterrey have often opted to send their exports to third countries via Houston because of the additional delays they would incur by sending them through the ports of Tampico or Altamira (*Latin American Regional Reports*, 1993). At the same time, a large proportion of imports from Asia are unloaded in United States ports and then transported to Mexico City overland rather than entering directly via the port of Manzanillo, because using Manzanillo would almost double both the cost and the time needed to receive the merchandise.

While Mexican customs administration has been simplified, thereby significantly reducing the time spent on the corresponding formalities, companies still experience difficulties in dispatching their exports through national ports because of obsolete port facilities. The decision to turn over the administration of several ports to the private sector and the outright privatization of some port facilities reflect the Mexican Government's determination to increase port management efficiency. It is also planned to make substantial investments for improving multimodal transport, so as to be able to combine container transport by truck, rail and ship.

The modernization prospects for Latin American port systems are generally encouraging. While modernization has been relatively slow because of the vast number of new rules which must be designed and implemented, some of the current changes aim to improve even on the conditions under which some ports operate in developed countries, especially with respect to collective bargaining, levels of decentralization, and customs procedures (Sgut, 1993).

e) Customs

Transit of goods through customs can be a serious hurdle for manufacturing firms in some countries of the region, both for importing inputs and for exporting their products. These difficulties are particularly significant for small and medium-sized companies, and this in practice limits the benefits of trade liberalization.

Most customs authorities in the region follow procedures designed for a highly complex system of tariff and para-tariff protection designed to meet trade protection needs, and adapting these practices to a context of trade liberalization and internationalization has not been an easy task. The trade liberalization processes initiated in several countries have led to the modification of some customs procedures, but much remains to be done in order to bring customs operations in line with the new orientation of the region's economies. Indeed, there are some countries which have liberalized their trade but have not experienced any significant increase in their foreign trade. One of the reasons advanced for this is that serious impediments still

exist in practice, since customs authorities still wield a good deal of discretionary power and their officials have too much leeway in the interpretation of existing regulations. In addition, the weakening of the public sector has prevented the necessary investments in infrastructure and in the training of customs officials, thus compounding the difficulties of enforcing the new regulations.

Modern customs authorities (such as those of the European Common Market) have changed their mode of operation so that there are now very few physical checks on traffic but there is more investigation of the tax, financial and accounting aspects of export and import operations. The most notable result of this trend has been the uninterrupted physical flow of goods, yet greater efficacy in curbing fraud. The almost complete elimination of direct contacts between customs officials and users has had the effect of inhibiting arbitrary actions and corruption.

f) Conclusions

It can be seen from the above that the disparity in the infrastructures available to companies in different countries of the region leads to differences in their levels of competitiveness. These differences affect companies' readiness to attempt to export their products, and sometimes they are even discouraged from importing inputs that would enable them to be competitive in the domestic market; these impediments are particularly severe for companies wishing to export manufactures, in which the region usually has less of a competitive edge than in products based on natural resources.

Some notable features of infrastructure as a determinant of company competitiveness may be identified:

i) Infrastructure supply is obviously a public asset because it generates strong externalities for productive activities as a whole. Because of the indivisible nature of the big investments it entails, this supply is characterized by conditions of increasing returns and monopolistic or heavily oligopolistic structures of ownership and control. This makes it imperative to formulate adequate regulatory frameworks that establish standards for disseminating the systemic effects deriving from tariff policy and infrastructure modernization.

ii) The need for increased investment in infraestructure, both to compensate for the sharp drop of the 1980s and to narrow the gap in per capita availability of services as compared with the developed countries and some newly industrialized countries, offers great opportunities for stimulating the domestic and intraregional supply of related engineering services. This would have a major spillover effect on the industries that produce inputs and capital goods for construction and heavy engineering.

4. Industrial restructuring policies

The growth of a country's varied economic activities is never a homogeneous process; while some sectors are innovative and increase their efficiency, others exhibit less dynamism or fall clearly behind. The term "restructuring" applies here only to situations where specific products or sectors have fallen behind. When the whole economy, or the whole industrial sector, has lost its competitiveness, it is likely that the problems are due to flaws in macroeconomic management (exchange-rate lag, high interest rates) or structural defects (insufficiently skilled labour, lack of complementary infrastructure), both of which require the adoption of global measures.

When a subsector of the economy falls behind or ceases to be competitive, this may be the result, among other factors, of sudden sharp reductions in the level of the subsector's relative effective protection; changes in key prices in the economy which erode the competitiveness of low-profitability subsectors; technological advances that render obsolete the production processes used or generate good substitutes for existing goods; the emergence of new competitor countries with comparative advantages in the sector (lower wages, cheaper raw materials); or the exhaustion of a natural resource on which a

particular activity is based. The problems arising from these situations can be aggravated when companies react to them too late out of inertia or because they do not know what to do.

a) Bases for a restructuring policy

If markets functioned perfectly and factors were fully mobile, nothing would need to be done in this respect. Declining competitiveness would be simply an indication that, in the new situation, the old allocation of factors in the economy had ceased to be efficient and must therefore be modified. Since factors could move freely and instantaneously, there would be no adjustment cost.

In reality, however, there are many barriers to factor mobility, while the functioning of markets exhibits imperfections that justify State action in that field (Atiyas *et al.*, 1992). These distortions include the many flaws in factor markets, as well as the externalities already mentioned; the specific characteristics of the equipment and plant installed and the human resource capital acquired, which limit the free movement of factors; lack of coordination by companies in adjusting to the new requirements of the different sectors; the multiplicity of often conflicting interests involved in the restructuring process —of owners, managers, workers, consumers and even government— as a result of which the pressures of individual agents can seriously impede the adoption of what would be the most opportune measures from the social point of view.

Some of these distortions thwart the adoption of restructuring policies by companies, seriously reduce their chances of success or increase the costs of a sharp contraction of the sector. Consequently, unless measures are taken to confront these distortions, they may lead to a waste of important productive potential and to high social costs.[32]

b) Elements for an industrial restructuring policy

Aside from the trade and productive development policies examined, a subsectoral restructuring policy comprises two kinds of actions: i) measures to create an environment that would stimulate and facilitate the early adoption by firms of action to overcome their lagging competitiveness; and ii) targeted restructuring programmes.

i) *Creation of an environment conducive to restructuring.* In order to maintain and increase the competitiveness of companies, it is necessary first of all to instil an attitude of foresight. To this end, it is of paramount importance, on the one hand, to send out clear signals that the authorities will not reward delays in making adjustments by adopting protectionist measures or awarding public subsidies and, on the other hand, to facilitate the necessary readaptation processes by taking steps to eliminate the above-mentioned obstacles and distortions that impede companies' restructuring efforts.

The first area of action is the dissemination of information on market behaviour, technological trends and, in general, the competitiveness of domestic producers. It must be reiterated that information is an asset which is subject to externalities and economies of scale, and it is therefore reasonable that the State should encourage its dissemination or provide this service directly. A technical unit could be created for this purpose to make periodic evaluations of the situation in the different branches of activity and of the global economic trends affecting them. The detection of

32 The possibility that the lack of an appropriate restructuring policy may have high social costs is also a pragmatic argument in favour of government action to aid an efficient industrial restructuring process: when confronted with a sharp sectoral contraction, there is always the risk that the authorities may be subjected to such pressure that they have to resort to a "rescue" operation to keep a specific activity artificially afloat. This would result in a waste of resources that would postpone or put an end to firms' decisions to restructure, with the further drawback that it would create unjustified incentives for companies

problems or anomalies in an area should then be followed up quickly by detailed studies to identify the proper course of action. Such a unit would have to have the assistance of the private sector both for guiding its activities and helping to finance it.[33]

A second area of action involves elements that facilitate factor mobility, especially that of labour, given its obvious impact on social equity. This involves strong support for training, outside as well as inside the company, in order to sustain a process of continuous adaptation of the labour force to the changes which companies must make, as well as measures in the direction of the introduction of unemployment insurance schemes linked to manpower retraining programmes and the creation of institutions that provide timely information on employment supply and demand. Attention should also be given to management training, especially in areas related to aspects of the production process, such as inventory management, organizational change and quality control systems.

A third key element of restructuring is the need for flexible instruments, rapidly accessible to their beneficiaries, enabling companies to obtain qualified advisory services or to strengthen their own research and development units.

ii) *Targeted restructuring programmes.* In spite of the above measures, it is possible that the resources available through programmes to support competitiveness will be insufficient to resolve severe, concentrated crisis situations. The most dramatic cases, which for that very reason deserve special intervention, are those in which the activity is highly concentrated in geographical terms and directly or indirectly generates a large share of the jobs in a region. There is then a need to implement targeted restructuring programmes, but only as an exception and selectively, since otherwise there would be a danger of delaying the necessary adjustment and making it even more costly.

These programmes should give firms a chance to regain competitiveness in their subsector or to specialize in other areas of the same sector,[34] but should not be confused with "rescue" programmes or serve to camouflage indiscriminate transfers of public resources to the private sector. The existence of the necessary technical and supervisory capacity on the part of the public sector is consequently an essential condition for the implementation of such programmes, in order to ensure strict supervision to determine whether steps are being taken in the right direction. Without this capacity, the risk of failure is very high and it is very likely that the programme will have a higher social cost than not intervening at all.

The exact design of the programme should be based on a diagnostic study of the situation and of the problems of the sector concerned (see box VIII.6). Such a study must be a shared effort by the parties involved —the government, employers and workers— in order to avoid working at cross-purposes. The generation of a degree of consensus among workers and em-

33 Another option is for the State to support the creation of private institutions which provide these services or the establishment of technical units based on business organizations. However, such options can leave smaller companies at a disadvantage and should therefore be considered as complementary, rather than as alternatives to a government service.

34 The irreversible loss of competitiveness of certain subsectors when they are the economic mainstay of a city or region is a separate case, of course. The management of such crises may require both the retraining of the workforce and its movement to other activities and regions, as well as transitory incentives for the installation of enterprises of other kinds in the region. The economic justification for such subsidies would of course be that they avoid the cost to the public (an externality for the enterprise) of creating the additional infrastructure needed in other areas of the country, while taking advantage of the existing physical and human infrastructure in the area, the opportunity cost of which would be very low or nil.

Box VIII.6

SPAIN'S EXPERIENCE WITH INDUSTRIAL RESTRUCTURING

In 1981, Spain adopted an Industrial Restructuring Act in order to provide a framework for dealing with problems of excess production capacity and lack of international competitiveness in a number of industrial sectors in Spain.

The Act was inspired by two basic principles. First, the initiative and responsibility for restructuring rested with the private sector, and government intervention must be kept to the minimum. Second, the Government was not supporting individual firms but the restructuring programme as a whole. The Act also emphasized the need for a concerted effort by the Government, employers and trade unions.

The specific purposes of the programme were to reduce excess installed capacity and overmanning, put firms' finances on a sounder basis, and contribute to the implementation of an investment programme which would make it possible to modernize the sectors involved.

In addition, complementary measures were adopted to minimize the social costs of restructuring, especially those created by lay-offs. One of the most important initiatives was the establishment of emergency reindustrialization zones in the areas most affected by restructuring processes. A series of incentives was created (tax reductions, subsidies and investment credits) in order to encourage firms to stay in those areas or move to them, and the Government provided funds to stimulate early retirement programmes and compensate those who had lost their employment. In the latter case, the unemployed workers were offered the opportunity to participate in a programme of retraining and assistance in finding new employment. Less than half the workers chose that option, however: the majority preferred to receive substantial severance payments.

An evaluation of the programme carried out in 1988 (López-Claros, 1988) showed that 77% of the 84,000 superfluous jobs had been eliminated and that 66% of the planned investments had been made. Mergers and specialization agreements had also been achieved in various sectors, supported by subsidized credits from the Government. Although the State had contributed a considerable amount of resources, improvements in the financial position of firms and faster growth of productivity were also evident. The weakest point of the programme was the unwillingness of redundant workers to look for new jobs, because of the generous benefits to which they were entitled.

Source: I. Aliyas *et al.*, *Fundamental Issues and Policy Approaches to Industrial Restructuring*, Industry Series Paper No. 56, Washington, D.C., World Bank, April 1992.

ployers is essential in order to ensure the success of the initiatives undertaken.

Decisions concerning the action to be taken should come from the firms themselves, but can be facilitated by the measures contemplated in the restructuring programme. In this respect, the heart of the programme should be the concentrated application at the sectoral level of the development instruments already available (including training incentives, support for technological innovation, and the provision of market information), which can be adapted to meet more effectively the specific needs of the sector concerned.

Nevertheless, there may be two problem areas which require special measures. The first arises when it is necessary to adjust installed sectoral capacity. It is very difficult for an efficient adjustment of this nature to be made independently, because each firm hopes that it will be others that abandon the market or decrease their production. Outside intervention to encourage the merging of firms or the closure of less efficient companies would provide a better outcome than the market solution. Experience shows, however, that if some firms remain outside the agreement reached and there is no effective system of incentives and penalties, the desired result may not be achieved.

The other problem area is access to financing for firms that are in the process of restructuring. If a given sector has prob-

lems of profitability, it is unlikely that financial institutions will be able to distinguish between firms with good prospects and those with little chance of success, since this would require very specialized technical capacity and the supervisory work required would be very costly. Instead of providing funds directly, the State might help to reduce the costs involved for credit institutions by promoting the establishment of specialized consulting firms to provide evaluation services to banks or, if there was a general feeling that this would be effective, directly subsidizing the financial institutions dealing with these cases. This would facilitate access to credit without generating the traditional problems of supervision or implicit guarantees normally involved in the provision of public funds.

5. Macroeconomic preconditions for a policy of productive development

High inflation causes firms to take a very short-term view, so that restructuring considerations are subordinated to more immediate needs, which —in the case of high inflation— often go no further than how to survive the next 30 days. It is no accident that in such circumstances the strategic decisions and investments required to achieve international competitiveness are postponed, no matter how favourable the relative prices for carrying out such restructuring may be. Moreover, given the uncertainty and instability characteristic of situations of high inflation, the response of firms to the micro and mesoeconomic policies attempted, as well as to current relative prices, becomes inelastic. However, this problem has been solved in most of the countries thanks to their successful stabilization efforts. Consequently, other macroeconomic factors take on greater importance.

In the external accounts, macroeconomic imbalances are also associated with big fluctuations in the terms of trade, international interest rates or capital inflows, which give rise to sudden and unstable adjustments in aggregate demand and rates of exchange. This hinders exports and the efficient production of import substitutes (whose expansion is more sensitive to long-term signals), while stimulating imports. Consequently, the greater the instability of trade accounts, current account balances or capital accounts, the lesser the credibility of the incentives in effect at a given moment and the greater, therefore, the incentives needed to achieve the desired response from economic agents, while there is a even bigger danger of falling into the trap of a costly "over-adjustment" such as occurred, for these reasons, in almost the whole of the region during the 1980s.

Macroeconomic instability is also reflected in an imbalance between aggregate demand and productive capacity. Such instability obviously leads to a sub-optimum rate of average use of that productive capacity, and its consequences are an actual productivity level lower than the potential level, as well as lower rates of profitability, which consequently discourage capital formation. In addition, the instability of aggregate demand and relative prices tends to discourage firms from making innovations that could increase their productivity.

The microeconomic consequences of macroeconomic imbalances are the reduction or postponement of investments designed to modernize equipment and processes, as well as of innovation efforts. Thus, for example, when they have a large part of their installed capacity idle and shorten their planning cycles, firms tend to give priority to activities with very short-term returns, to the serious detriment of expenditures on investment and development. One very damaging effect of reductions in these expenditures is the frequent dismantling of entire engineering departments or the loss of critical masses of work on innovation, adaptation, design and development, with the consequent loss of know-how and technological capacity acquired at such a high cost during the substitution industrialization stage. Moreover, this attention to the short term

even affects efforts to find new methods and processes, above all if these involve expensive visits abroad. Finally, as Brazil's recent experience shows (see box VIII.1), although macroeconomic instability does not completely delay all innovation efforts, the shortage of resources and the uncertainty which necessarily accompany it lead to an emphasis on "soft technologies", whose full potential can only be realized by complementary investments in modern equipment, processes and plants ("hard technologies").

The subject of macroeconomic policies, particularly as they relate to capital movements and the stability of key prices such as exchange rates, is taken up in Part Three.

Part Three

MACROECONOMIC STABILITY AND INTERNATIONAL FINANCIAL FLOWS

Chapter IX

INTERNATIONAL FINANCIAL FLOWS IN LATIN AMERICA AND THE CARIBBEAN

1. Background

Since the beginning of the 1990s, the countries of Latin America and the Caribbean have received large net amounts of external capital. During the first four years of this decade, the flow of capital towards the region reached an annual average of US$ 44 billion. In 1992 alone, the net flow "peaked" at US$ 62 billion and for 1993 it was estimated to reach US$ 55 billion (see table IX.1).

This extremely large capital flow is somewhat surprising. On the one hand, it represents an abrupt turnaround as regards the equally noteworthy restriction in the matter of external finance which the region had to face during practically the whole of the 1980s, as a result of the external debt crisis. This turnaround was of dramatic scale: between 1983 and 1989 the net entry of capital, on average, was only US$ 8 billion a year (see table IX.1), while the recovery was of surprising magnitude: the net entry of capital in 1992 was 50% higher than the previous peak, recorded in 1981 —the last year before the debt crisis exploded, with the consequent collapse of financial flows. Even in 1993, when the flow showed signs of levelling-off, the flow of capital was still 35% above that of the year before the crisis. Likewise, as a proportion of the GDP of Latin America and the Caribbean, the net entry of capital represented 5% in 1992 and 4% in 1993, compared with a coefficient of 4.6% in 1981 (see table IX.2) and only 1.2% in 1983-1989.

Because of this abundant flow of capital, combined with lower interest payments on the external debt, the region registered a net positive transfer of resources for the first time since the beginning of the crisis. Thus, in 1991 the transfer became positive again, with a value of US$ 8 billion, while for 1992 it rose to US$ 33 billion and for 1993 it was estimated at US$ 26 billion. In terms of regional GDP, the positive transfer in these last two years was 2.7% and 1.9%, respectively, compared with an average negative figure of 3.7% of the regional product in 1983-1989 (see table IX.3).

Nearly all the Latin American and the Caribbean countries benefited in the 1990s from this spectacular expansion of capital inflows. However, in some of them the turnaround was especially marked. The most noteworthy case was that of Mexico: while it generated a quarter of the output of Latin America and the Caribbean, it absorbed 60% of the capital movements towards the region between 1983-1989 and 1990-1993, with the annual average flow of capital towards Mexico rising from a negative balance of US$ 660 million between 1983 and 1989 to a positive inflow of more than US$ 21 billion in 1990-1993. Expressed as a percentage of GDP, the annual flow changed from a negative balance of 0.4% to a positive one of 8.3%. Argentina has also been a very important recipient of

Table IX.1

LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL MOVEMENTS [a]

(Millions of dollars)

	1950-1965	1966-1973	1974-1976	1977-1981	(1981)	1982	1983-1989	1990	1991	1992[b]	1993[c]
Latin America and the Caribbean	**881**	**4 334**	**14 956**	**29 437**	**40 514**	**21 107**	**8 424**	**21 576**	**39 356**	**61 973**	**54 605**
Latin America and the Caribbean (excluding Venezuela)	**932**	**4 224**	**14 561**	**27 986**	**44 562**	**25 045**	**10 036**	**26 937**	**38 900**	**59 647**	**53 285**
Oil-exporting countries	**274**	**1 601**	**5 449**	**12 297**	**17 632**	**3 835**	**533**	**8 863**	**25 851**	**31 789**	**32 425**
Oil-exporting countries (excluding Venezuela)	**325**	**1 491**	**5 054**	**10 846**	**21 680**	**7 773**	**2 145**	**14 224**	**25 395**	**29 463**	**31 105**
Bolivia	26	23	72	253	493	230	378	355	444	780	810
Colombia	34	289	338	956	1 941	2 182	879	53	-527	167	1 520
Ecuador	11	105	165	705	653	863	503	549	741	915	825
Mexico	192	924	3 425	8 154	17 393	2 806	-662	11 643	21 882	24 670	25 090
Peru	61	149	1 054	778	1 200	1 692	1 046	1 624	2 855	2 931	860
Venezuela	-51	110	394	1 451	-4 048	-3 938	-1 612	-5 361	456	2 326	1 320
Non-oil-exporting countries	**607**	**2 733**	**9 507**	**17 139**	**22 882**	**17 272**	**7 892**	**12 713**	**13 505**	**30 184**	**22 180**
South America	**438**	**2 025**	**7 828**	**14 664**	**19 757**	**13 974**	**5 308**	**9 988**	**9 439**	**25 952**	**17 835**
Argentina	108	92	142	1 895	1 519	1 684	1 757	1 476	5 433	12 910	10 000
Brazil	210	1 727	7 244	9 329	12 382	11 113	1 991	5 054	1 640	8 802	3 440
Chile	87	169	207	2 627	4 942	1 033	1 260	3 075	1 404	3 487	2 890
Paraguay	7	29	106	339	420	316	198	263	818	515	785
Uruguay	24	8	129	473	494	-172	103	120	144	238	720
Central America and the Caribbean	**169**	**709**	**1 679**	**2 475**	**3 125**	**3 299**	**2 584**	**2 725**	**4 066**	**4 232**	**4 345**
Barbados	4	36	49	66	134	44	1	-13	-9	...	...
Costa Rica	17	83	232	455	360	398	437	364	515	587	695
El Salvador	3	19	114	68	224	210	297	535	299	482	495
Guatemala	21	44	186	184	273	361	361	205	740	738	1 020
Guyana	3	22	60	76	148	139	54	...	...	...	...
Haiti	8	15	106	111	185	141	172	179	154	76	100
Honduras	8	35	146	219	250	174	303	341	400	371	210
Jamaica	25	139	174	79	122	302	323	550	192	...	...
Nicaragua	10	57	175	225	735	593	755	468	935	1 076	775
Panama	31	71	206	235	-50	136	-285	362	516	398	485
Dominican Republic	4	91	157	402	438	311	275	72	457	504	565
Suriname	17	28	58	83	136	111	-30	10	...	...	...
Trinidad and Tobago	18	66	15	271	171	379	-78	-347	-133	...	...

Source: ECLAC, on the basis of official data.

[a] Includes Long- and short-term capital, Unilateral official transfers and Errors and omissions. [b] Preliminary figures. [c] Estimate.

Table IX.2

LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL MOVEMENTS

(Percentages of gross domestic product) [a]

	1950-1965	1966-1973	1974-1976	1977-1981	(1981)	1982	1983-1989	1990	1991	1992	1993[b]
Latin America and the Caribbean	**1.2**	**2.8**	**4.2**	**4.5**	**4.6**	**2.8**	**1.2**	**2.0**	**3.6**	**5.1**	**4.2**
Latin America and the Caribbean (excluding Venezuela)	**1.4**	**3.0**	**4.5**	**4.6**	**5.4**	**3.7**	**1.5**	**2.9**	**4.1**	**5.2**	**4.4**
Oil-exporting countries	**1.0**	**2.5**	**3.7**	**4.6**	**4.3**	**1.2**	**0.2**	**2.6**	**7.4**	**7.1**	**6.7**
Oil-exporting countries (excluding Venezuela)	**1.6**	**2.8**	**4.4**	**5.0**	**6.3**	**3.2**	**0.9**	**4.8**	**8.5**	**7.6**	**7.4**
Bolivia	3.9	2.4	2.9	7.1	13.1	8.8	6.0	10.6	12.7	22.4	22.0
Colombia	0.8	4.0	2.4	3.4	5.4	5.4	2.3	0.1	-1.2	0.4	3.0
Ecuador	1.3	6.1	3.6	7.3	4.9	6.8	4.7	5.4	6.7	6.0	-1.1
Mexico	1.7	2.6	4.2	5.1	6.5	1.7	-0.4	5.7	10.4	8.7	8.5
Peru	2.4	2.1	7.6	4.5	4.9	6.7	4.2	4.8	9.2	7.0	6.2
Venezuela	-0.8	0.9	1.0	2.9	-6.1	-5.8	-3.0	-11.3	1.3	3.9	2.1
Non-oil-exporting countries	**1.3**	**3.0**	**4.6**	**4.5**	**4.8**	**4.0**	**1.9**	**1.8**	**2.0**	**4.0**	**2.8**
South America	**1.0**	**2.5**	**4.1**	**4.1**	**4.4**	**3.5**	**1.4**	**1.5**	**1.5**	**3.7**	**2.4**
Argentina	0.7	0.4	0.4	2.0	1.3	2.5	2.5	1.0	2.9	5.9	4.2
Brazil	1.0	3.6	5.5	4.1	4.4	3.8	0.7	1.0	0.3	2.0	0.9
Chile	2.0	2.0	2.3	12.7	16.2	4.3	6.5	11.0	4.5	9.3	7.1
Paraguay	2.7	4.5	6.8	10.2	8.5	6.2	5.4	4.4	9.5	7.6	10.9
Uruguay	2.1	0.4	3.6	6.2	4.3	-1.6	1.7	1.5	1.0	2.2	5.3
Central America and the Caribbean	**4.8**	**8.7**	**10.5**	**9.2**	**10.3**	**10.6**	**7.6**	**7.3**	**10.4**	**9.7**	**9.4**
Costa Rica	4.0	9.0	11.8	12.7	13.3	16.1	10.3	6.4	9.2	9.0	9.8
El Salvador	0.5	1.8	6.4	2.1	6.5	5.8	6.2	9.8	4.9	7.5	7.1
Guatemala	2.2	2.4	4.7	2.7	3.2	4.1	4.6	2.6	8.0	7.2	9.3
Haiti	...	4.4	21.6	13.5	20.3	15.0	14.1	11.4	9.2	5.7	8.1
Honduras	2.3	5.1	12.3	9.7	8.8	6.0	8.1	11.6	13.6	11.2	6.0
Nicaragua	5.8	7.2	11.3	11.0	29.7	21.2	34.4	27.4	57.1	69.8	49.5
Panama	7.7	6.9	11.4	8.0	-1.3	3.2	-6.0	7.3	10.7	6.6	7.3
Dominican Republic	0.6	6.0	4.8	7.8	7.7	5.7	5.3	1.0	6.2	6.3	6.7

Source: ECLAC, on the basis of official data.

[a] The estimates of gross domestic product in current dollars were obtained on the basis of data on GDP in national currency and the exchange rate for exports of goods and services, taken from the IMF Balance of Payments serires.

[b] Preliminary estimates.

Table IX.3

LATIN AMERICA AND THE CARIBBEAN: NET TRANSFER OF RESOURCES [a]

(Porcentages of gross domestic product) [b]

	1950-1965	1966-1973	1974-1976	1977-1981	(1981)	1982	1983-1989	1990	1991	1992	1993[c]
Latin America and the Caribbean	-0.6	0.7	2.4	1.9	1.1	-2.5	-3.7	-1.2	0.9	2.7	1.9
Latin America and the Caribbean (excluding Venezuela)	0.4	1.2	2.6	1.7	1.7	-2.0	-3.5	-0.8	1.0	2.8	2.1
Oil-exporting countries	-2.2	-0.1	1.8	1.9	1.1	-4.3	-4.7	-1.3	4.1	4.2	4.0
Oil-exporting countries											
(excluding Venezuela)	0.3	0.8	2.2	1.5	2.3	-3.3	-4.3	0.6	4.8	4.7	4.7
Bolivia	3.7	0.3	2.0	1.8	3.5	-7.0	0.9	3.3	5.8	16.9	16.6
Colombia	-0.2	0.8	0.0	1.6	4.0	3.0	-2.2	-5.3	-5.9	-3.7	-0.3
Ecuador	-0.9	3.4	0.5	3.2	-0.2	0.3	-4.1	-5.0	-1.9	-1.0	-7.5
Mexico	0.2	0.9	2.0	1.6	2.4	-5.9	-5.6	1.8	7.1	6.2	6.1
Peru	0.7	0.1	5.7	0.0	0.7	2.6	-0.4	1.8	6.3	4.7	4.1
Venezuela	-9.5	-4.5	0.6	3.3	-5.2	-8.0	-6.7	-12.9	0.1	1.0	-1.2
Non-oil-exporting coutries	0.4	1.3	2.8	1.9	1.2	-1.2	-3.0	-1.3	-0.9	1.8	0.7
South America	0.4	1.2	2.6	1.7	1.0	-1.6	-3.5	-1.5	-1.3	1.6	0.4
Argentina	0.4	-0.7	-0.6	0.4	-1.9	-4.4	-5.1	-3.2	-0.2	3.8	2.6
Brazil	0.2	2.5	4.0	1.4	0.7	-0.8	-3.3	-1.4	-1.6	0.2	-1.2
Chile	0.3	-0.1	-0.9	8.9	11.4	-3.7	-3.3	4.5	-1.3	4.4	3.2
Paraguay	2.2	2.9	5.0	9.0	8.1	6.7	2.8	3.7	8.8	6.8	9.8
Uruguay	1.5	-0.7	1.9	5.2	3.6	-3.4	-3.5	-2.5	-1.8	0.5	4.1
Central America and the Caribbean	0.8	2.6	5.0	4.0	5.2	3.8	4.3	2.9	6.4	5.7	6.5
Costa Rica	1.9	6.8	9.0	7.9	2.0	1.1	2.8	2.1	6.2	5.9	7.1
El Salvador	-0.1	0.8	4.7	0.0	3.5	3.1	3.7	7.6	2.8	5.9	5.6
Guatemala	1.9	0.5	3.3	2.0	2.0	2.7	2.3	0.0	6.5	5.4	8.0
Haiti	...	-0.8	5.7	13.5	23.9	22.6	12.4	9.9	7.6	5.0	7.7
Honduras	0.3	1.8	9.6	4.7	3.4	-1.0	2.4	3.0	5.5	1.6	-3.1
Nicaragua	2.8	3.7	7.6	5.8	22.5	14.6	24.2	14.7	34.9	37.7	22.0
Dominican Republic	-1.2	3.9	1.8	4.0	2.8	1.0	0.3	-1.1	3.3	3.3	3.9

Source: ECLAC, "Postwar Transfer of Resources Abroad by Latin America", *Cuadernos de la CEPAL* series, No. 67 (LC/G.1657-P), Santiago, Chile, 1991. United Nations publication, Sales No. E.91.II.G.9.

[a] Net transfer of resources equals the net imports of capital (Unilateral official transfers, Short-term and long-term capital and Errors and omissions), minus net profits and interest, which include both the interest effectively paid and the interest due but unpaid. In this table, negative amounts indicate transfers of resources abroad. [b] The estimates of gross domestic product in current dollars were obtained on the basis of data on GDP in national currency and the exchange rate for exports of goods and services taken from the IMF Balance of Payments series. [c] Preliminary estimates.

capital: between the two periods, the average flow as a proportion of GDP increased from 2.5% to 4.2%. Brazil, Chile, Peru, Guatemala and Venezuela have also received exceptionally large capital inflows in the 1990s (see tables IX.1 and IX.2).[1]

2. The new capital movements in historical perspective

a) The tight financial situation of the 1950s

In the first decade after the war, Latin America faced substantial and persistent financial constraints. In fact, between 1950 and 1965 the annual average inflows of external resources received by the region barely represented 1% of its GDP: not enough to compensate for the outflows in the form of profits and interest on external capital. As a result the net transfer of resources to the region was negative in this period (see table IX.3).[2] It is interesting to note, however, that in this time of financial constraint the countries of the region attained fairly acceptable rates of growth of GDP, of the order of 5.5% a year.[3]

This financial situation was due largely to external factors. Among these it is noteworthy that in the 1950s the capital markets of the northern hemisphere were oriented mainly towards domestic financing (Hayes, 1977), due partly to the fact that investors recalled the non-compliance with many international obligations during the period between the two wars, some of it attributable to Latin America (ECLAC, 1964). Moreover, controls had been established over the movement of capital by the industrialized countries, which were still in the process of economic reconstruction. At that time, most of the external financing came from foreign direct investment (FDI) (equivalent to 60% of the net flow of capital), and from medium- and long-term loans (40% of the net total), awarded initially by suppliers or their governments and, from the 1960s onwards, by the multilateral financial agencies (see table IX.4). Private financing was generally limited to the short term and to specific projects with State guarantees.

b) An expansionary financial cycle: from the mid-1960s to the early 1980s

In the mid-1960s the capital accounts of the Latin American and Caribbean economies began to be more dynamic owing, to a large extent, to new events in the international economy. Thus, there now began a broad, expansionary phase of external financing, within an equally expansionary international financial cycle, which was to extend up to the debt crisis of 1982. The increase in the external financial flows received by the economies of the region was as significant as it was widespread: already in the early 1970s the capital flows represented, on average, 3% of regional GDP. This expansion was further intensified in the second half of the 1970s and the early 1980s, when flows reached 4% to 5% of GDP (see table IX.2).

This large increase in capital inflows was due mainly to external factors. In fact, the very development of the industrialized countries' banking sector exerted a decisive influence. Firstly, we must mention the general change that occurred in banking circles in the 1950s: a period in which

1 The countries of Central America and the Caribbean showed the most modest growth in average capital flows between 1983-1989 and 1990-1992 (table IX.1). This was partly because this subregion was not faced in the 1980s with such a sharp contraction in the flow as that observed in most Latin American countries; in its turn, this reflects the fact that the economies of Central America and the Caribbean have relatively greater access to official loans and donations, which usually represent a relatively stable source of external financing. This subregion also benefits from quasi-capital flows in the form of transfers by nationals working abroad.

2 During this period Venezuela recorded large net outflows of capital and profits. Excluding Venezuela, the entry of capital and transfer of resources from the countries of the region were equivalent to 1.4% and 0.4% of GDP, respectively.

3 For a more detailed analysis of this period, see Ffrench-Davis, Muñoz and Palma (1994).

Table IX.4

LATIN AMERICA AND THE CARIBBEAN: NET CAPITAL MOVEMENTS, BY TYPE OF TRANSACTIONS

(As percentages of total)

	1950-1965	1966-1973	1974-1976	1977-1981	(1981)	1982	1983-1989	1990	1991	1992[a]	1993[a]
Latin America and the Caribbean	100	100	100	100	100	100	100	100	100	100	100
Long-term capital	106	83	92	101	129	188	123	18	86	70	...
Foreign direct investment	63	27	14	17	19	28	55	30	28	31	...
Portfolio investment	0	2	2	5	6	22	6	86	38	23	...
Loans	43	55	76	79	104	138	62	-98	19	13	...
Short-term capital	10	11	14	2	-1	-33	-26	58	11	29	...
Donations	10	4	2	2	2	4	19	15	7	6	...
Errors and omissions	-27	1	-8	-5	-30	-59	-16	9	-4	-5	...

Source: ECLAC, on the basis of data provided by IMF.
[a] Preliminary estimates.

a "new" banker appeared, less marked by the financial crises of the 1930s. This, together with the excess liquidity in the financial markets of the industrialized countries and the decline in the participation of the banks in those markets, meant that banking executives were more and more ready to apply an expansionary strategy to place the funds available for loans (Hayes, 1977). Initially, their field of action was limited to domestic markets, but during the 1970s this expansionary strategy began to be extended to the international level.

During the major part of the 1960s the banks concentrated their expansionary forces on the markets of the OECD countries which enjoyed greater solvency; however, the intense competition in those markets and the resulting reduction in the margins of intermediation, together with the marked recessionary trend which affected the OECD economies in 1969-1970, induced the bankers to explore new markets in the developing countries.[4]

While in the period 1966-1981 the private international banks were undoubtedly the main driving force behind the dynamic supply of external financing to the region, there were other factors which also helped to feed this huge flow of external capital. The oil crises of 1973-1974 and 1979-1980 gave a strong impetus to this capital movement. On the one hand, a strong demand arose in connection with the current-account financing of the oil-importing countries; on the other, there was an increase in the apparent creditworthiness of the oil-exporting countries, which became a preferred objective in the internationalization strategy of the private banks. Similarly, the great influx of "petrodollar" deposits into the international banking system accelerated the expansion of their loans. The governmental policies of the OECD countries also helped to swell

4 For a more detailed analysis of the factors which contributed to the banks' expansion, see Devlin (1989).

the flow of resources, given the existence of negative real domestic interest rates[5] and the bank regulations in force, which became extremely lax in the early 1970s. The Latin American countries, for their part, displayed passive receptiveness in the face of an aggressive supply.[6]

It is worth recalling that there was a great deal of optimism about the boom in bank loans. Bankers, international organizations and many analysts applauded without reservations the abundant flows from the banks; indeed, many countries thought that they had finally been freed from the paternalism of official financing.[7]

The expansionary phase of the credit cycle continued almost without interruption between 1966 and 1981. However, there was a brief crisis in mid-1974, which illustrated the fragility of the financial systems and showed how international financial cycles can have a life of their own. At this time a small German bank, Herrstatt, failed after incurring losses through speculation on the European exchange markets. Although this failure was in no way linked to Latin America, it had important consequences for the region, for as a result of the panic set off in banking circles, towards the end of 1974 the flow of loans to Latin America was paralysed, their cost went up drastically, and repayment terms were notably reduced, all of which made the servicing of the debt and the macroeconomic management of the countries of the region more difficult. The market settled down again in the second quarter of 1975, bringing with it a renewed flow of bank loans to the region.[8]

Another result of the expansion of bank lending was the heavy accumulation of liabilities with variable interest rates. At the beginning of the 1980s Latin America's external debt already exceeded US$ 300 billion, of which over three-quarters corresponded to private bank loans. At that date, the total value of the regional debt exceeded the critical level of solvency of 200% of export earnings, and its servicing absorbed one-third of exports (ECLAC, 1988b), while interest payments on the external public debt represented between 10% and 25% of tax revenue.[9] Furthermore, the banks' enthusiasm for issuing loans led them to take excessive risks: thus, at the beginning of the 1980s the nine biggest United States banks had accumulated loan exposure in Latin America equivalent to nearly 200% of their capital (ECLAC, 1990b). In short, the permissiveness then reigning in the unregulated international capital market and the adoption of frankly pro-cyclical public policies with respect to taking advantage of the great capital supply placed the region in a position of vulnerability which created favourable conditions for a crisis.

c) The financial constraints of the 1980s

As is well known, the debt crisis began in August 1982 when Mexico declared that it could not continue to service its bank debt, the second biggest in the developing world. In the months following Mexico's failure to pay, the negative externalities that usually occur in the midst of a financial crisis were exacerbated by the banks' panic, which led them to almost completely cut off new loans to the Latin American countries, including countries like Colombia that had been very cautious in the management of their capital inflows. As loans

5 The negative real interest rates led many analysts, including certain international bodies, to think that external indebtedness was "good business" for the developing countries.

6 The only exception was Colombia, which distinguished itself by the caution with which it managed the supply of loans from the international financial markets (Junguito and Perry, 1983).

7 So great was the faith in market criteria that some even thought that the International Monetary Fund had become redundant as far as regulation of the macroeconomic policies of the developing countries was concerned (Morgan Guaranty Trust, 1976).

8 Portfolio investment, for its part, continued to represent only a small fraction of the total external resources available.

9 For an analysis of this phenomenon, see Altimir and Devlin (1993).

were not renewed, this meant that the countries of the region, except Colombia, found themselves in a situation of de facto non-compliance with their debt service commitments to the banks. *De jure* non-compliance was avoided only thanks to a rescue operation agreed by the creditors, which enabled the countries to formally meet their obligations.[10]

While this rescue operation avoided formal non-compliance, it had an enormous social cost for the region, because an integral part of the rescue was the requirement that the countries should adjust their economies, generally within the framework of a programme agreed with the IMF, the objective being to generate a trade surplus large enough to enable them to service the bulk of the dollar interest due on the commercial bank debt.

In this context, the negative transfer of resources from Latin America (i.e., from the region to the rest of the world) reached a level also without precedent. Between 1982 and 1986, it was equal to 4% of the region's GDP: an even bigger proportion than Germany had had to pay after the First World War as reparations to the Allies (ECLAC, 1991b). Because of the size of this transfer and the very short term over which it had to be paid, it was clear that it could only be achieved at the cost of a spectacular reduction in imports (40%) and a sharp economic recession in the region.[11]

The heavy capital flight by residents of Latin America and the Caribbean also fuelled the crisis and aggravated the problem of the transfer of resources abroad. This phenomenon was reflected, in part, in the negative balances recorded under the entries "Errors and omissions" and "Short-term capital" in the capital accounts of the region during the first half of the 1980s (see table IX.4). On the basis of a fairly common methodology recently employed by the World Bank, it may be concluded that capital flight reached a very significant order of magnitude in 1980-1983: about US$ 90 billion.[12] It must also be remembered that, at this time, there were high rates of interest on deposits in international markets, a fact which gave even more impetus to the flight. Before the crisis broke out, capital flight was concentrated in Mexico, Trinidad and Tobago, Argentina and some Central American countries. This reflects the fact that in these countries national agents anticipated the beginning of the crisis.[13] After 1982, however, the flight became widespread and was related to the recessionary adjustment that the debtor countries had to make, under strong pressure from their creditors. As indicated below, although the capital of domestic agents was the first to flee, it was apparently also among the first to come back in the 1990s.

The high cost of Latin America's debt crisis may have been partly the result of the type of capital received by the region from the 1970s onward, for the artificial rescue of the value of the loans, through reprogramming of payments of principal and the granting of new "involuntary" loans by the banks in the 1980s,[14] was not subject to a direct market valuation, so that it was easier for the banks to insist that the nominal value of the debt must be respected. Unlike the portfolio investors of the 1930s, the banks could isolate themselves from market forces, which probably would have forced the bank creditors to accept immediate and substantial losses on their loans.

Indebtedness with the banks had two other characteristics which heightened the impact of the crisis in Latin America. Fir-

10 For a detailed analysis of this rescue operation, see ECLAC (1984a).

11 For more details on the effects of the adjustment, see ECLAC (1984a and 1986) and chapter XI of the present document.

12 We stress "order of magnitude" because there is no consensus on what constitutes "capital flight" nor on how to calculate it. We shall go more deeply into this subject later.

13 In Central America political uncertainty also exerted an influence.

14 See ECLAC (1984a) for a study of the rescue techniques.

stly, by contrast with the atomized market of bondholders of the 1930s, the banks operated in an oligopolistic market which enabled private creditors to create a quasi-cartel in order to exert effective pressure on the debtor countries. Secondly, the capital flows were owed, to a disproportionate extent, to a single creditor (the banks) and the resulting concentration of credit was so excessive that it became a systemic risk for the international financial markets. As a result, the governments of the OECD countries decided to intervene actively to overcome the crisis, but unfortunately their action was not at all even-handed, since it helped to transfer most of the cost of the crisis to the debtors.[15]

During the second half of the 1980s there were some novel changes in capital movements. As the debt crisis persisted, a secondary market for the external debt paper began to arise, and the heavy discounts at which this paper was traded revealed publicly what was already suspected: the real value of the debt was much lower than its nominal value. The development of the secondary market had two other important positive effects. Firstly, from 1985 onwards, the countries used the big discounts in the secondary market to initiate involving the swapping of debt for equity in programmes of national enterprises, thus facilitating the financing of privatization operations, and the subsidy implicit in these operations served to stimulate foreign investment flows through these channels, especially from 1987 onwards (Fuentes, 1992 and Calderón, 1993b) (see table IX.5).[16]

Secondly, the development of the secondary market and the growing discounts undermined the credibility of the official crisis-management strategy, in which it was not envisaged that the banks should register any losses. As regards external debt service, which was a heavy burden for the debtors, from 1987 onwards growing arrears of interest payments built up. For Latin America, these arrears represented substantial forced inflows of capital. At the beginning of the 1990s, the accumulated arrears amounted to more than US$ 25 billion (of which US$ 21 billion were for bank credits), a sum equal to about 30% of the net capital inflows registered between 1983 and 1990 (see table IX.6). Although the accumulated arrears served as a safety-valve to counter the debt pressures, however, they are in fact a relatively inefficient form of external financing. Fortunately, together with the decline in international interest rates in recent years and the increase in non-compensatory capital flows, there has been a trend towards the regularization of payments, since at the end of 1992 the region's arrears of interest payments had already gone down to about US$ 12 billion.

3. The resurgence of capital movements in 1990-1993

As we have seen, over the last 20 years, the region has been affected by abrupt capital movements that have often perturbed macroeconomic management. Moreover, the fluctuations of financing were often determined by external factors. Thus, as the financial rationing of the 1980s clearly gave rise to severe adjustments, the return of capital flows in the 1990s obviously had initial positive effects, since it put an end to the external constraints which had affected the region since the financial crisis of 1982. Indeed, the economic recovery and the greater price stability in recent years were directly linked to the greater external leeway permitted by the entry of capital. This, in turn, confirmed the perception that external financing was an important ingredient missing from the official adjustment programmes of the previous decade (ECLAC, 1990a). However, the favourable impact of the capital flows over the medium term will depend on

15 For an analysis of the biased nature of the official handling of the debt, see ECLAC (1990b).

16 For a detailed analysis of these programmes, see Bouzas and Ffrench-Davis (1990), Islam and Hilton (1993) and ECLAC (1990b).

Table IX.5

LATIN AMERICA (SELECTED COUNTRIES): FOREIGN INVESTMENT FLOWS (FDI), BY TYPES OF INSTRUMENT, 1988-1992

(Millions of dollars)

Country/instrument	1988	1989	1990	1991	1992	1993[c]	1988-1992
Argentina	1 147	1 028	1 836	2 439	4 179	3 300	10 629
Normal FDI flows	807	869	-80	1 586	2 112	732	5 294
Debt/equity swaps	340	159	815	-	-	-	1 314
Privatization [a]	0	0	1 101	853	2 067	2 568	4 021
Brazil	2 969	1267	901	972	1 454	2 000	7 563
Normal FDI flows	882	321	618	850	1 359	...	4 030
Debt/equity swaps	2 087	946	283	68	95	...	3 479
Privatization	0	0	0	54	0	...	54
Chile	1 027	1 505	691	563	737	850	4 523
Normal FDI flows IED	2	69	249	563	737	850	1 620
Debt/equity swaps [b]	886	1 321	442	0	0	0	2 649
Privatization	139	115	0	0	0	0	254
Colombia	203	576	500	457	790	850	2 526
Normal FDI flows	203	576	500	405	790	...	2 474
Debt/equity swaps	0	0	0	0	0	...	0
Privatization	0	0	0	52	0	...	52
Mexico	2 594	3 037	2 632	4 762	5 366	6 000	18 391
Normal FDI flows	1 671	2 648	2 432	3 956	5 275	...	15 982
Debt/equity swaps	868	389	85	19	0	0	1 361
Privatization	55	0	115	787	91	...	1 048
Peru	26	59	41	-7	127	200	246
Normal FDI flows	26	59	41	-7	-13	...	106
Conversion of capital debt	0	0	0	0	0	...	0
Privatization	0	0	0	0	140	...	140
Venezuela	89	213	451	1 916	629	750	3 298
Normal FDI flows	39	30	148	161	473	...	851
Debt/equity swaps	50	183	303	256	142	...	934
Privatization	0	0	0	1499	14	...	1 513
Latin America [d]	8 855	7 685	7 052	11 102	13 282	13 950	47 176
Normal FDI flows	3 630	4 572	3 908	7 514	10 733	...	30 357
Debt/equity swaps	4 231	2 998	1 928	343	237	...	9 737
Privatization	194	115	1 216	3 245	2 312	...	7 082

Source: Alvaro Calderón, "Inversión extranjera directa e integración regional: la experiencia reciente de América Latina y el Caribe", Industrialización y desarrollo tecnológico, series No. 14 (LC/G.1778), Santiago, Chile, ECLAC, September 1993, and additional information provided by the Joint ECLAC/UNCTAD Unit on Transnational Corporations.

[a] All the FDI flows into Argentina during 1990-1992, through external debt conversion, form part of the privatization programme. [b] The investments made in Chile were incorporated through the external debt conversion programme (Chapter XIX). [c] Estimates. [d] This total includes only Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.

Table IX.6
LATIN AMERICA AND THE CARIBBEAN: EXTERNAL DEBT INTEREST ARREARS [a]
(Millions of dollars)

	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991
Total	**129**	**247**	**916**	**1 893**	**-489**	**791**	**4 861**	**327**	**8 167**	**9 120**	**-3 889**
Oil-exporting countries	**12**	**47**	**114**	**419**	**536**	**713**	**1 280**	**668**	**766**	**881**	**-464**
Bolivia	12	39	26	95	137	56	48	-306	-58	-44	7
Colombia	0	0	0	0	5	-5	2	-1	2	25	-8
Ecuador	0	0	0	0	9	4	446	341	271	460	570
Mexico	0	0	0	0	0	0	0	0	0	0	0
Peru	0	8	88	324	384	657	782	635	548	446	-1 033
Venezuela	0	0	0	0	1	1	2	-1	3	-6	0
Non-oil-exporting countries	**117**	**200**	**802**	**1 474**	**-1 025**	**78**	**3 581**	**-341**	**7 401**	**8 239**	**-3 425**
South America	**28**	**29**	**919**	**1 270**	**-1 118**	**-212**	**2 912**	**-1 034**	**6 552**	**7 542**	**-3 035**
Argentina	0	0	837	1 237	-1 297	-291	-135	1 777	3 405	1 699	1 833
Brazil	28	29	74	27	166	54	3 033	-2 838	3 162	5 803	-4 888
Chile	0	0	0	0	0	0	0	0	0	0	0
Paraguay	0	0	8	6	13	25	14	27	-15	40	20
Uruguay	0	0	0	0	0	0	0	0	0	0	0
Central America and the Caribbean	**89**	**171**	**-117**	**204**	**93**	**290**	**669**	**693**	**849**	**697**	**-390**
Costa Rica	84	145	-214	51	-53	67	140	60	105	-305	-14
Dominican Republic	3	6	4	60	-41	27	89	59	75	224	82
El Salvador	0	0	0	0	2	2	1	4	14	-17	0
Guatemala	0	0	0	10	30	19	24	13	21	81	5
Haiti	0	0	0	9	2	-1	1	5	-1	8	-9
Honduras	2	2	7	19	14	19	44	28	29	-52	-12
Nicaragua	0	18	85	55	139	158	354	229	304	354	-661
Panama	0	0	1	0	0	-1	16	295	302	404	219

Source: O. Altimir and R. Devlin, "An overview of debt moratoria in Latin America", Development Policy Review, vol. 11, No. 4, December 1993.
[a] Net annual cumulative figures.

their stability and cost over time, as well as on the efficiency with which economic policy uses the capital flows to meet the needs of macroeconomic stability, changing production patterns, international competitiveness and social equity. A summary analysis of the volume and nature of the different capital flows in the 1990s is given below.

a) Types of flows

Besides the increase in the volume of external resources mobilized, the recovery of capital flows in the 1990s has been characterized by a significant diversification of financing sources. Thus, the banks have been largely displaced by other important flows, especially foreign direct investment and portfolio investment (see table IX.7).

i) *Financing with indebtedness*

Commercial banks. It is estimated that the contribution of the banks to the external financing of the region amounted to US$ 9.5 billion in 1992. This is about 16% of total flows: a small fraction of its share in the 1970s. Although the net financing provided by the banks was a good deal greater than that supplied in 1991, it was mostly short-term. This reflects their attitude to Latin America, which has been restrictive since the crisis. In 1992, Argentina, Brazil and Chile were very active borrowers in this segment of the market. In the first months of 1993, there was a mod-

Table IX.7
LATIN AMERICA: SOME SOURCES OF EXTERNAL FINANCING
(Millions of dollars)

	1989	1990	1991	1992[a]	1993[a]
A. Debt					
Bonds[b]	900	3 600	7 600	10 100	19 300[g]
Banks[c]	-6 497	8 559	6 800	9 500	...
Commercial paper	127	-	1 210	840	...
Certificates of deposit	-	-	670	1 100	...
B. Investment					
Direct[d]	6 134	6 522	10 898	14 087	...
ADR/GDR[e]	-	98	4 260	4 390	3 342[g]
External funds[f]	608	483	771	259	...

Source: ECLAC, on the basis of official data.
[a] Preliminary. [b] Gross value. [c] Net, short- and medium-term. [d] Includes reinvestment of profits. [e] ADR = American Depository Receipts; GDR = Global Depository Receipts. [f] Only closed funds; initial capital. [g] January-October.

est expansion in the net loans made to the region. Brazil, Chile and Mexico featured prominently in this, especially in the contracting of short-term trade credits. Syndicated loans came to nearly US$ 2.5 billion, but it is possible that this segment of the market will become more dynamic.

Bonds. From 1989 onwards, the Latin American and Caribbean countries obtained extensive access to the international bond market: a source of financing to which the region had had only limited recourse since before the Great Depression. In fact, its entry into this market has been on a noteworthy scale: in the first 10 months of 1993 the countries of the region issued almost US$ 20 billion in bonds, —practically double the total registered during the whole previous year (see table IX.8). In 1992, bond issues were equivalent to 17% of the region's financing, and in 1993 they probably exceeded 40% (see tables IX.1 and IX.7).

The countries most active in the bond market have been Mexico, Brazil, Argentina and Venezuela. They have been joined by a growing number of other countries, however, Chile and Colombia entered the market in 1991; Trinidad and Tobago and Uruguay began to issue bonds in 1992, while in 1993 a Central American country (Guatemala) participated for the first time (see table IX.8).

Apart from the growth in the number of transactions and participants, there are other signs of growing receptiveness in this segment of the market. For example, the size of new bond issues is increasing; in March 1993 a private Mexican firm and in June a United States subsidiary of the Venezuelan State Petroleum Enterprise made "jumbo" bond issues of US$ 1 billion each. Furthermore, in relation to the LIBOR rate, the bond margins have often been higher, especially in Argentina and Brazil, as compared with Chile, Mexico and Colombia.

Nevertheless, financing through bond issues continues to be relatively expensive. The initial yields offered on bonds are around 8% to 10% for terms of three to five years, and there has also been some lengthening of the terms (up to 7 years) (see table IX.9).[17]

17 It should also be noted that the initial costs of incorporation in a new financing market are typically high. In time, it is hoped that competition between lenders will help to reduce bond charges.

Table IX.8

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): INTERNATIONAL BOND ISSUES [a]

(Millions of dollars)

	1989	1990	1991	1992	1993
Total	**900**	**3 600**	**7 600**	**10 100**	**19 300**
Argentina	-	-	800	1 500	3 400
Brazil	-	-	1 600	3 300	5 500
Colombia	-	-	200	-	400
Chile	-	-	300	100	200
Guatemala	-	-	-	-	60
Mexico	600	3 400	4 100	4 100	7 400
Trinidad and Tobago	-	-	-	100	100
Uruguay	-	-	-	100	140
Venezuela	300	200	600	900	2 200

Source: West Merchant Bank and Bank for International Settlements (BIS).
[a] Gross financing.

Table IX.9

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): INDICATORS OF INTERNATIONAL BOND CONDITIONS [a]

	1990		1991		1992		1993[b]	
	Yield[c]	Term[d]	Yield[c]	Term[d]	Yield[c]	Term[d]	Yield[c]	Term[d]
Argentina	-	-	10.6	3.2	9.3	...	8.7	3.4
Brazil	-	-	12.2	2.7	10.6	2.8	9.7	3.9
Chile	-	-	...	...	...	...	7.4	7.5
Colombia	-	-	...	...	-	-	7.5	3.1
Mexico	13.1	3.7	10.7	5.6	9.8	4.9	8.3	5.3
Trinidad and Tobago	-	-	-	-	11.8	5.0	...	...
Uruguay	-	-	-	-	8.6	3.0	...	...
Venezuela	14.0	5.0	10.4	4.3	9.6	5.0	8.8	4.0

Source: West Merchant Bank.
[a] Averages, weighted by a very broad sample of the bonds offered. [b] January-October. [c] Initial yields in percentages. [d] Terms in years.

ii) *Foreign investment*[18]

Foreign investments of risk capital have assumed considerable importance in the region. In 1992, the last year for which information is available for all the Latin American countries, the identifiable flows of foreign capital reached US$ 19 billion, a figure equivalent to 30% of the net inflow of capital received by the region (tables IX.4 and IX.7).

Foreign direct investment (FDI). It is estimated that in 1992 —the last year for which relatively complete data exist— the flow of FDI to the region was close to US$ 14 billion, compared with US$ 11 billion in 1991 and US$ 6.5 billion in 1990. As in 1991, the value of FDI registered in 1992 was high in historical terms. The share of these flows in the total amount of capital rose to 25% in the biennium 1991-1992, compared with 17% in 1977-1981 (see table IX.10).

In 1992 there were substantial increases in FDI flows, especially in Mexico, Brazil, Argentina, Chile, Costa Rica and the Dominican Republic.

In Mexico, the FDI inflow was more than three times the annual average for the period before the crisis (see table IX.10). This boom in direct investment is linked to a large extent to the announcement and subsequent ratification of the North American Free Trade Agreement (NAFTA) and the profound economic reforms carried out in Mexico.

Chile has also received a strong flow of direct investment. The average annual inflow of almost US$ 700 million in 1991-1992 was notably higher than the US$ 140 million received during the crisis years and the US$ 200 million received annually between 1977 and 1981. Moreover, in 1991-1992 the investment was made without the benefit of the big subsidies offered between 1985 and 1989, when foreign investment benefited from the national debt/equity conversion programme (see table IX.5).[19]

In the case of Argentina, the FDI flow of US$ 4.7 billion in 1992 was almost double the amounts recorded in 1991 and 1990. Four-fifths of these investments were attracted by the ambitious programme for privatizing public enterprises (Calderón, 1993b).

The FDI flow to Venezuela declined from US$ 1.77 billion in 1991 to US$ 550 million in 1992, largely because of the poralyzation of the privatization programme. As for the increased flow of FDI to Costa Rica, this was due in part to the efficiency of the official incentives programme (in respect of assembly industries, for example) for foreign investors (Rodríguez, 1993).

It is difficult to specify the yield required by FDI, because of serious problems of measurement. However, a rough indicator may be the estimate made by the United States Department of Commerce regarding the rate of return on FDI from the United States to Latin America. This statistical base suggests that in recent years FDI has usually been gaining relatively high annual yields of the order of 15%-20% (see table IX.11).

American Depository Receipts (ADR).[20] While these instruments came into being in 1927 and there are now more than 700 ADR and GDR programmes, only in the last few years has there been active participation by developing countries in this

18 The word "foreign" is not totally appropriate; as will be seen below, Latin American residents are repatriating capital through financial instruments which have traditionally been associated with foreigners.

19 In this sense, the Chilean programme was a pioneering one. For an analysis of the subsidies offered, see Ffrench-Davis (1990).

20 ADRs are negotiable certificates issued by United States banks. They represent a share package in foreign companies. ADRs are quoted on the United States stock exchanges and give the holder the same rights as any other shareholder of the State in which they are issued. There is also a variant of ADRs (Global Depository Receipts-GDRs), which are certificates circulating simultaneously on various stock exchanges of the world.

Table IX.10

LATIN AMERICA AND THE CARIBBEAN: NET FOREIGN DIRECT INVESTMENT [a b]

(Millions of dollars)

	1977-1981	(1981)	1982	1093-1989	1990	1991	1992
Latin America and the Caribbean	**5 080**	**7 792**	**5 894**	**4 663**	**6 522**	**10 898**	**14 087**
Oil-exporting countries	**1 866**	**3 508**	**2 364**	**2 263**	**3 362**	**7 090**	**6 964**
Bolivia	33	76	31	5	26	50	91
Colombia	98	228	337	533	484	433	740
Ecuador	55	60	40	67	82	85	95
Mexico	1 541	2 835	1 655	1 677	2 633	4 762	5 366
Peru	60	125	48	13	41	-7	127
Venezuela	78	184	253	-32	96	1 767	545
Non-oil-exporting countries	**3 214**	**4 284**	**3 530**	**2 400**	**3 160**	**3 808**	**7 123**
South America	**2 798**	**3 721**	**3 215**	**2 038**	**2 569**	**3 043**	**6 310**
Argentina	483	944	257	586	2 008	2 439	4 179
Brazil	1 930	2 313	2 534	1 285	236	-42	1 308
Chile	204	383	401	143	249	563	737
Paraguay	31	32	37	5	76	83	86
Uruguay	150	49	-14	19	...	...	...
Central America and the Caribbean	**416**	**564**	**315**	**362**	**591**	**765**	**813**
Barbados	6	7	4	3	10	6	14
Costa Rica	53	66	27	75	160	173	217
El Salvador	6	-6	-1	18	2	25	...
Guatemala	116	127	77	110	48	91	94
Guyana	0	-2	4	2	...	...	...
Haiti	10	8	7	7	8	14	...
Honduras	11	-4	14	34	44	45	60
Jamaica	-9	-12	-16	11	138	127	87
Nicaragua	4	0	0	0	0	0	15
Panama	3	6	3	17	-17	-40	-1
Dominican Republic	65	80	-1	73	133	145	179
Suriname	2	35	-6	-50	-43	11	-30
Trinidad and Tobagoo	150	258	204	63	109	169	178

Source: ECLAC, on the basis of IMF figures and those provided by national bodies.

[a] Including debt conversions, except for Chile. [b] Net foreign direct investment represents foreign direct investment inflows into the country, less foreign investments made by nationals. These latter data are not available for all the countries of the region, which explains the differences with table IX.5.

Table IX.11
RATE OF RETURN ON FOREIGN DIRECT INVESTMENT OF UNITED STATES ORIGIN [a]
(Percentages)

	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1990	1991	1992
All countries	**18.2**	**14.7**	**9.9**	**9.9**	**10.1**	**12.8**	**12.6**	**13.4**	**15.5**	**15.0**	**14.3**	**11.5**	**10.7**
Developing countries	**23.5**	**23.1**	**16.9**	**12.1**	**15.2**	**13.8**	**12.0**	**13.1**	**16.4**	**18.0**	**17.0**	**16.0**	**17.5**
Latin America [b]	**14.2**	**12.2**	**3.2**	**-0.3**	**6.6**	**7.6**	**8.8**	**10.9**	**17.0**	**18.8**	**14.2**	**13.6**	**18.6**
Argentina	29.9	3.9	16.8	12.5	2.2	4.7	13.3	11.6	13.8	1.8	17.2	19.4	17.3
Brazil	6.6	6.3	8.7	1.5	5.9	6.1	9.2	12.8	19.9	26.3	10.0	6.5	17.8
Chile	1.7	23.3	-12.4	21.5	42.6	93.3	53.8	40.8	44.3	29.1	20.4	16.8	17.0
Colombia	7.2	5.4	13.3	7.6	9.5	12.6	7.1	3.2	6.1	4.2	20.6	18.3	18.1
Ecuador	0.0	17.4	14.5	11.3	19.9	25.4	21.2	6.6	1.1	7.1	9.7	10.1	15.8
Mexico	22.1	21.0	-18.7	-6.2	7.7	13.7	4.4	14.4	23.6	20.3	19.9	20.3	19.6
Peru	0.0	22.6	13.3	6.0	5.7	-2.0	-0.3	-4.0	-10.8	-14.6	-17.3	-3.8	1.6
Venezuela	5.3	14.3	12.4	-30.8	8.8	3.9	13.5	7.5	13.7	7.8	15.0	22.1	30.8

Source: Joint ECLAC/UNCTAD Unit on Transnational Corporations, on the basis of data published in Survey of Current Business, United States Department of Commerce, Washington, D.C., various issues.

[a] This rate of return was calculated as the income from foreign direct United States investment (reinvested profits plus distributed profits) divided by the average stock of these investmens between the beginning and end of each years at historical prices. However, the main limitation in using historical prices for this purpose is that they give rates of return which may differ from the returns on other similar investments made at different times and at different prices. [b] Including Argentina, Belize, Bolivia, Brazil, Chile, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Mexico, Nicaragua, Paraguay, Peru, Suriname, Uruguay and Venezuela. The Caribbean island countries were not included, nor was Panama, since most of the foreign direct investment from the United States is concentrated in the financial sector.

market. In 1992, a number of Latin American enterprises issued US$ 4.4 billion in ADR and GDR —equal to 7% of the total flow of net external financing received by the region— in order to obtain dollar capital. This amount compares with US$ 4.3 billion in 1991 and US$ 100 million in 1990, the first year in which an enterprise from the region issued certificates of this type. The market continued to be buoyant in 1993, and in the first 10 months of that year Latin American firms sold ADR and GDR totalling more than US$ 3.3 billion (see tables IX.7 and IX.12).

The country which has made most use of ADRs and GDRs is Mexico. In 1992, 10 new programmes were launched for obtaining fresh capital of US$ 3.5 billion, i.e., almost 80% of the resources mobilized by regional enterprises through this instrument. While the number of Mexican issues continued to be high in 1993, their average volume declined, as may be seen from the fact that they totalled only US$ 970 million in the first 10 months of the year (see table IX.12).

In 1992 two Argentine firms mobilized some US$ 375 million through ADR and GDR issues, while in the first ten months of 1993, Argentine companies obtained US$ 2.1 billion —63% of the total value of ADRs and GDRs issued— mainly through an issue made by the privatized firm Yacimientos Petrolíferos Fiscales (YPF). Chile was the pioneer in the use of ADRs, since in 1990 its privatized telephone company issued the first certificates from the region for an amount close to US$ 100 million. During 1992, two programmes totalling US$ 130 million were launched, while in 1993 four new operations totalling US$ 250 million were registered. In the biennium 1992-1993 companies from Brazil, Colombia and Venezuela joined the ADR market.

Offshore investment funds. This financial mechanism was added to the market in the 1980s with the aim of facilitating

Table IX.12

LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): ISSUES OF AMERICAN DEPOSITORY RECEIPTS (ADRs) FOR NEW CAPITAL FORMATION [a]

	Number of transactions				Amount in millions of dollars			
	1990	1991	1992	1993[b]	1990	1991	1992	1993[b]
Total	**1**	**15**	**19**	**16**	**98**	**4 260**	**4 390**	**3 342**
Argentina	-	1	2	3	-	364	376	2 098
Brazil	-	-	1	-	-	-	133	-
Chile	1	-	2	4	98	-	130	248
Colombia	-	-	1	1	-	-	27	27
Mexico	-	14	10	8	-	3 896	3 508	969
Venezuela	-	-	3	-	-	-	216	

Source: S. Gooptu, Portfolio Investment Flows to Emerging Markets, Policy Research Working Papers series, No. 1117, Washington, D.C., World Bank, 1993; Latin Finance, various issues, and ECLAC, Economic Development Division..

[a] Including Global Depository Receipts (GDR). [b] January-October.

foreign investment in the new emerging stock markets of developing countries. The administrators of a fund ask the authorities of a developing country for the right to buy and manage a portfolio of shares to be traded on the local stock exchange; the fund is subscribed in dollars and is quoted on foreign stock exchanges. The funds may be "open", i.e., with the right to increase the initial capital, or "closed", with only one capital offering when the fund is established. It is estimated that at the end of 1993 there were more than 40 offshore funds operating with regional portfolios and more than 20 funds specializing in individual countries.

In 1992 the establishment of new closed offshore funds —which represent only a part of the investment funds' activity— generated capital flows on the order of US$ 260 million (see table IX.13).[21]

As regards the yield offered by these investment funds, a sample of some of the funds with the best performance covering Chile, Brazil and Mexico suggests that there is a fair amount of variability, associated with the big fluctuations in stock-market quotations. Thus, in March 1993 the best yield was that of Mexico (an average of 7%), while in the case of Chile there was a loss of 6%. In September 1993, the highest return was 4.9% attained in Brazil, compared with a loss of 4.8% in Mexico (World Bank, 1993a).

iii) *Other flows*

While there are few data available for 1993, it is known that in 1992 other capital flows into the region came to about US$ 21 billion. Most of these were short-term credits. In 1992 the region also obtained US$ 1.1 billion through the issue of certificates of deposit (compared with US$ 670 million in 1991) and US$ 840 million through commercial paper (compared with US$ 1.2 billion in 1991) (see table IX.7).

As regards the terms of indebtedness, certificates of deposit carry terms of two to three years, and in 1992 their spread over LIBOR varied from 2.3% for Mexico to 2.8%-

21 These figures may underestimate the total flow generated by the funds.

Table IX.13
LATIN AMERICA AND THE CARIBBEAN (SELECTED COUNTRIES): NEW CLOSED OFFSHORE INVESTMENT FUNDS [a]

	Number of transactions				Amount in millions of dollars			
	1989	1990	1991	1992	1989	1990	1991	1992
Total	**8**	**5**	**11**	**4**	**608**	**383**	**771**	**259**
Argentina	-	-	1	-	-	-	56	-
Brazil	-	-	1	1	-	-	43	56
Chile	3	2	-	-	230	180	-	-
Mexico	3	-	1	-	192	-	71	-
Venezuela	-	-	1	-	-	-	100	-
Regional	2	3	7	3	186	203	501	203

Source: S. Gooptu, Portfolio Investment Flows to Emerging Markets, Policy Research Working Papers series, No. 1117, Washington, D.C., World Bank, 1993, and ECLAC, Economic Development Division.
[a] Including Global Depository Receipts (GDR).

4.7% for Argentina and Brazil. In the case of commercial paper, their term of repayment is less than a year, with spreads over LIBOR of between 2.8% and 3.8% for Argentina in 1992 (Goldstein and Folkerts-Landau, 1993). It is also known that substantial foreign resources have entered Mexico through the purchase of treasury bills (treasury certificates or readjustable bonds) expressed in pesos. It is estimated that in 1992 capital inflows by this mechanism amounted to US$ 9 billion.

It is difficult to break down the remaining resources. However, it may be assumed that in 1992 the bulk of them (some US$ 10 billion) were acquired by the region's banking systems as interest-bearing short-term deposits or recycled domestically, in the form of increases in enterprises' working capital or investments on the stock exchange or in real estate. In particular, direct portfolio investment in the stock market may have been highly significant. In Mexico, for example, it is estimated that 19% of the capital increase on the Mexican Stock Exchange came from foreign investment, while in Argentina, the proportion was over 25% (Gooptu, 1993).

b) Factors behind the resumption of capital flows

There are a varied range of factors, both national and international, that explain the substantial inflow of capital into Latin America during the 1990s.

The external and internal factors underlying the capital movements of the region are varied and it is hard to determine their relative importance. However, we know that the structural reforms of the Latin American economies and the high domestic interest rates are not completely new: they have been present to a greater or lesser extent since the mid-1980s. In contrast, the abrupt changes in two determinants of financial profitability in the countries of the northern hemisphere (low interest rates and slower economic growth) are recent events which more or less coincide with the renewed external capital flows. Indeed, this is the conclusion of Calvo, Leiderman and Reinhart (1993). In their econometric study of 10 Latin American countries in 1988-1991 they conclude that external factors, particularly the fall in United States interest rates, have exerted considerable influence on the development of the Latin American capital

account, and in at least five countries have been the most influential factor.

i) *The fall in international dollar yields.* The recession in the United States and the sharp fall in international dollar interest rates, especially short-term ones, seem to have acted as strong external stimuli from 1990 onwards. The LIBOR short-term dollar rate registered an annual average of 11% in 1979-1988 and 9% in 1989, but from 1992 onwards it fell to less than 4%, the lowest level in 30 years. In real terms, its fall was even more marked: from annual averages of 4.4% in 1979-1988 and 4.6% in 1989, it declined to less than 1% in 1992-1993 (see table IX.14). Long-term dollar interest rates also declined, although to a lesser extent. For example, the yield on long-term United States Government bonds fell from an annual average of almost 11% in 1979-1988 and 8.5% in 1989 to 7% in 1992 and 6% during the first eight months of 1993.

The reduction in international interest rates was originally a phenomenon that occurred primarily in the "dollar zone"; in fact, the rates in Europe and Japan went up at the beginning of the 1990s, but they too showed a downward trend as from 1992 and 1993, respectively (see table IX.14).

After a decade of high yields on dollar loans, the sharp fall in the international interest rate in dollars obviously led investors to reassign part of their dollar portfo-

Table IX.14
INTERNATIONAL INTEREST RATES
(Percentages)

	1972-1978	1979-1988	1989	1990	1991	1992	1993[a]
Dollars							
A. LIBOR (180 days)							
Nominal	7.9	10.9	9.3	8.3	6.1	3.9	3.4
Real	-0.8	4.4	4.6	3.2	1.7	0.9	0.6
B. United States Government bonds							
Nominal	7.4	10.7	8.5	8.6	7.9	7.0	6.0
Real	-1.2	4.3	3.8	3.4	3.4	3.9	3.1
Marks							
A. LIBOR (180 days)							
Nominal	...	6.6	7.2	8.8	9.4	9.4	7.3
Real	...	0.4	2.6	3.6	4.9	6.2	4.4
B. Long-term German Government bonds							
Nominal	8.0	7.6	7.1	8.9	8.6	8.0	6.6[b]
Real	-0.7	1.4	2.5	3.7	4.2	4.8	3.7
Yen							
A. LIBOR (180 days)							
Nominal	...	6.6	5.5	7.9	7.2	4.4	3.3
Real	...	0.4	1.0	2.7	2.7	1.3	0.5
B. Long-term Japanese Government bonds							
Nominal	7.8	6.8	5.1	7.4	6.5	4.9	4.1
Real	-0.8	0.6	0.5	2.2	2.1	1.9	1.3

Source: ECLAC, on the basis of IMF figures.
[a] January-August. [b] January-June.

lio. This movement, together with the drop in real estate yields and in the profits of United States enterprises (Calvo, Leiderman and Reinhart, 1993) made it even more attractive to invest in Latin America, a region which continued to offer very high yields on short- and medium-term capital. Moreover, the risk premium applied by investors to these yields was probably lowered to the extent that the creditworthiness of countries indebted in dollars improved as a result of the drop in international interest rates and the bigger supply of funds, which reduced the risk of exchange-rate devaluation.

ii) *The persistence of high yields on capital in Latin America.* As already noted a large volume of short-term external capital has entered the Latin America banking systems. During the 1990s, the *ex post* difference between international interest rates in dollars and those prevailing on the capital markets of Latin America (in dollar equivalents) was often extraordinarily high in favour of the latter region.[22] The differences in yield have varied sharply from one year to another, but recently the biggest differences have been recorded in Brazil, Peru and Guatemala, as well as in Mexico, Costa Rica, Chile and Bolivia (see table IX.15).

Although it is difficult to make a precise calculation, it is known that a large part the external capital has seized the spectacular opportunities for profits offered by the region's stock markets. Figure IX.1 shows that the behaviour of these profits as a whole between 1990 and the third quarter of 1993 was extremely dynamic, for in the 1990s the share price index in dollars increased more on the Latin American stock exchanges than on those of Asia, the United States, the United Kingdom and Japan, with the stock exchanges of Chile, Argentina, Mexico and Colombia being particularly attractive in this respect.

Privatization operations were another incentive that helped channel capital towards the region. Between 1990 and 1992, Latin American public enterprises worth some US$ 40 billion were privatized, the process being particularly intense in Mexico, Argentina, Chile, Venezuela and Peru (see table IX.16). Investments in most of the big privatized undertakings, especially those in the public service sectors, have been attractive because of the potentially high yields offered by captive markets and, in a number of cases, the modest prices asked.[23] This was reflected in active participation by foreign companies in the direct purchase of public enterprises, which also led to new investments designed to expand and improve the goods and services produced by the newly privatized companies; this phenomenon was particularly marked in Argentina and Venezuela (see table IX.5).

Furthermore, governments also sold shares in privatized enterprises to the general public on local stock exchanges, thus influencing the behaviour of the latter, as well as to investors with foreign capital, either directly, through ADR and GDR programmes and offshore investment funds, or indirectly, through deposits made in Latin American banking systems from the exterior. Where the share package on sale was big compared with the size of the domestic market, selling stock abroad sometimes constituted a good way of reducing the possibility of saturating the local market with shares and thus causing a fall in prices. For example, when 160 million shares of Yacimientos Petrolíferos Fiscales (YPF) of Argentina were placed on sale, with a value of more than US$ 3 billion, 75% of them

22 The reasons for the high interest rates in the region differ according to the situation. In some countries they reflected restrictive monetary policies, motivated by efforts to control aggregate demand and domestic prices. In other cases, they were linked to the shortage of capital and exchange instability.

23 There are quite a few indications of a notable under-valuation of the sale prices of public enterprises. For an analysis of this phenomenon and other aspects of the privatization programmes in the region, see Devlin and Cominetti (1993).

Table IX.15

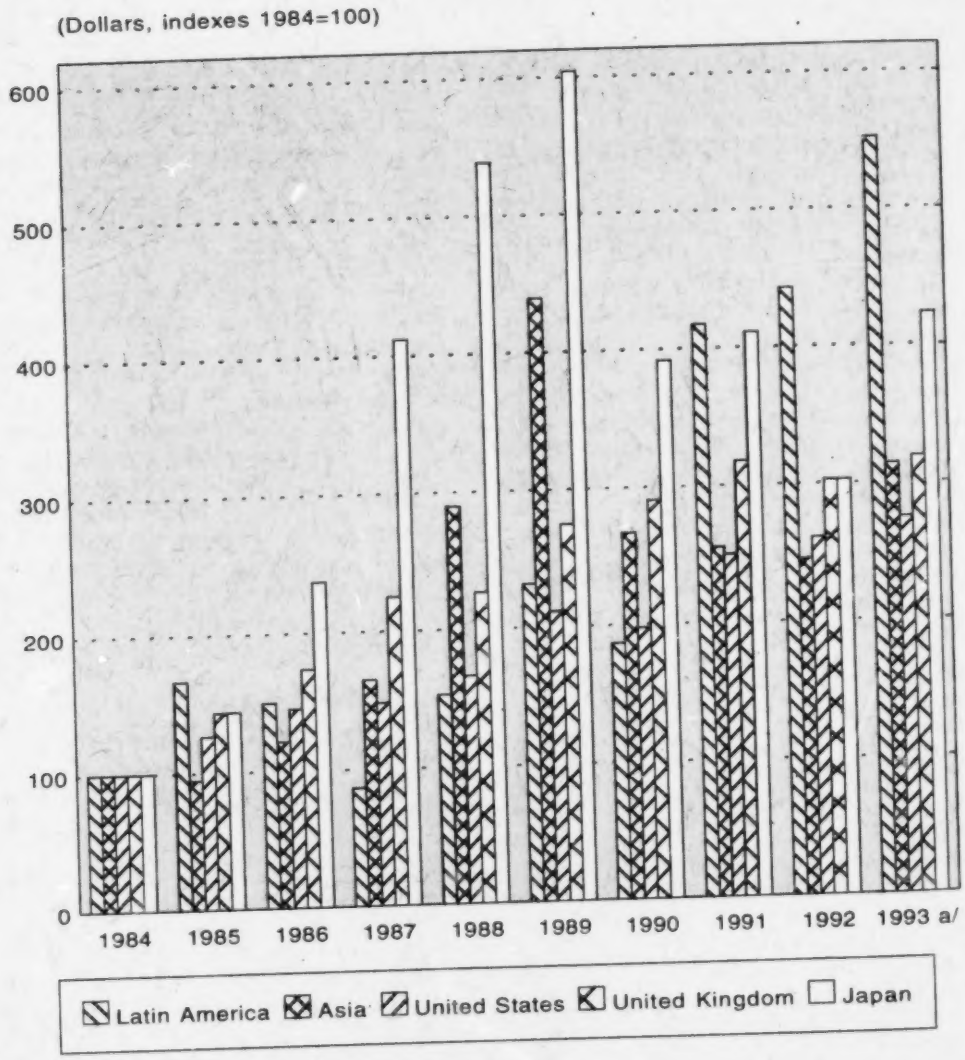
LATIN AMERICA: DIFFERENCES BETWEEN NATIONAL AND INTERNATIONAL INTEREST RATES [a b]

	1989	1990	1991	1992	1993[c]
Argentina [d]					
Short-term	26.4	127.7	-12.6	9.2	7.5
Long-term	27.2	127.5	-14.4	6.1	4.8
Bolivia					
Short-term	-6.4	0.0	6.2	8.5	10.6
Long-term	-5.7	-0.2	4.4	5.4	8.0
Brazil					
Short-term	98.8	-2.0	24.1	36.9	19.2
Long-term	99.6	-2.2	22.3	33.8	16.5
Chile					
Short-term	-3.3	15.7	4.1	12.6	-0.8
Long-term	-2.5	15.5	2.3	9.5	-3.5
Colombia [e]					
Short-term	-9.3	-8.4	3.7	5.5	8.0
Long-term	-8.5	-8.6	1.9	2.4	5.4
Costa Rica					
Short-term	-0.1	-8.8	-8.8	11.2	7.0
Long-term	0.7	-9.0	-10.6	8.1	4.3
Ecuador					
Short-term	-13.8	-3.7	-7.9	0.2	18.2
Long-term	-13.1	-3.9	-9.7	-2.9	15.6
El Salvador					
Short-term	7.0	-19.7	9.4	-4.8	25.8
Long-term	7.8	-19.9	7.6	-7.8	23.1
Guatemala					
Short-term	-14.7	-10.0	16.6	2.3	-7.1
Long-term	-13.9	-10.2	14.8	-0.8	-9.8
Honduras					
Short-term	-0.7	-58.5	2.5	1.0	...
Long-term	0.1	-58.7	0.7	-2.1	...
Mexico					
Short-term	9.0	8.9	6.1	10.2	14.0
Long-term	9.7	8.7	4.3	7.1	11.4
Peru					
Short-term	75.8	-42.2	76.9	4.7	-4.4
Long-term	76.5	-42.4	75.1	1.6	-7.1
Uruguay					
Short-term	-4.6	-7.9	4.8	5.2	2.9
Long-term	-3.8	-8.1	3.0	2.1	0.2
Venezuela					
Short-term	-29.6	3.2	2.8	2.2	20.3
Long-term	-28.8	3.0	1.0	-0.9	17.6

Source: ECLAC, on the basis of official data and statistics of the International Monetary Fund (IMF).

[a] National deposit rates, equivalent in dollars, lesss international dollar interest rates. [b] Short-term rates correspond to national rates, less LIBOR, while long-term rates correspond to national rates, less the yields of United States Government bonds. [c] First half of 1993. [d] New and revised series. [e] New series.

Figure IX.1
REGIONAL INDEXES OF SHARE PRICES ON STOCK EXCHANGES
(Dollars, indexes 1984=100)



Source: International Finance Corporation (IFC).
[a] Average January-September.

Table IX.16
LATIN AMERICA (SELECTED COUNTRIES): INCOME RESULTING FROM PRIVATIZATION

	Number of sales	Income [a] (millions of dollars)				Total
	1989-1992	1989	1990	1991	1992	1989-1992
Argentina	43	-	2 105	2 592	6 094	10 791
Brazil	17	-	-	1 658	2 340	3 998
Colombia	16	52	72	670	82	876
Mexico	130	730	3 205	10 831	7 007	21 773
Peru	14	-	-	3	264	267
Venezuela	13	-	9	2 290	20	2 319
Total	**233**	**782**	**5 391**	**18 044**	**15 807**	**40 024**

Source: ECLAC, Economic Development Division.
[a] If the privatization was financed with external debt paper, this was valued at secondary market prices.

were bought by investors living in the United States and Europe.

The difference between capital yields in Latin America and the industrialized countries also partly explains the region's capacity to sell bonds abroad. The yield of the Latin American bonds, with fairly short terms, was higher than that of United States Government bonds with terms that were four to six times longer (see tables IX.9 and IX.14).

As the capital supply was stimulated by the relatively high yields promised by investments in the region, the demand for their financing tended to be directed at external markets, attracted by the lower costs of new capital. Interest rates on loans obtained in Latin American capital markets have generally been very high because of a combination of high real interest rates in local currency and exchange revaluations which make the cost of domestic credit even dearer, compared with external credit. In the first two two-month periods of 1993, for example, the dollar equivalent costs of such loans were almost 45% in Peru, 40% in Bolivia, 22% in Costa Rica, 12% in Chile, 23% in Argentina, 18% in Honduras, 6% in Guatemala and 35% in Ecuador (see table IX.17). Indeed, the rates on loans in Latin American markets became so high that, in many cases, the available capital was confined to very short terms or was rationed by some lenders. In this context, it is only logical that many enterprises in the region decided to seek working capital and medium-term financing abroad.

iii) *The economic policies of the Latin American countries.* The economic policies of the countries of the region have undoubtedly also influenced the boom in capital flows. Many of the countries, to varying degrees have carried out a series of profound structural reforms whose effects have included the following: they have stabilized the expectations of private agents and increased the productivity and profitability of private investments; they have offered foreign investors equal or better conditions than local investors; and through the policy of liberalization, especially of the capital account, they have reduced the transaction costs and the risks involved in the movement of capital between the national and international mar-

Table IX.17
LATIN AMERICA: DOLLAR EQUIVALENT RATES FOR LOANS TAKEN OUT ON DOMESTIC CAPITAL MARKETS [a]

	1988	1989	1990	1991	1992	1993[b]
Argentina	40.6	1 087.5	138.0	-8.8	13.1	22.6
Bolivia	...	14.2	24.1	28.0	32.6	40.0
Brazil [c]	...	...	...	...	...	151.7
Chile	16.9	12.8	31.6	15.8	22.2	12.4[d]
Colombia	1.1	11.0	10.7	18.3	17.8	19.5[e]
Costa Rica	11.4	22.0	9.0	6.2	27.9	22.4
Ecuador	-25.3	-11.6	0.2	1.8	9.5	34.6
El Salvador	17 0	18.5	-8.9	19.0	3.1	29.4
Guatemala	7.1	-2.9	2.4	32.2	15.0	6.3
Honduras	15.4	15.4	-46.3	18.8	13.7	18.2[d]
Mexico	...	...	...	...	...	...
Peru	...	131.6	29.5	504.9	67.9	44.9[d]
Uruguay	31.0	28.8	39.5	60.0	54.0	50.4
Venezuela	8.5	-25.3	11.9	7.8	5.2	19.1

Source: ECLAC, on the basis of official figures and IMF data.
[a] Average quarterly values. [b] Average for two quarters. [c] Consumer credits. [d] Average for three quarters. [e] First quarter.

kets. The reforms have been recognized by the market as is clear from the investment risk ratings assigned by Moody's Investors Service and Standard and Poor (S&P) of the United States.

Capital flows have also been stimulated by the "neutral" economic policies of a large number of governments. In cases where the sterilization of capital inflows was not very marked, they were reflected in exchange rate appreciation, an increase in the trade deficit, and greater demand for financing. The relative permissiveness shown by many governments in their systems of regulation of external liabilities has also contributed to the increase in these flows.

iv) *Institutional changes in international markets*. Apart from their interest in taking advantage of the relatively high yields offered in Latin America, it has been observed that many portfolio investors abroad are gradually modifying their investment strategy. The "emerging markets" of the developing countries are not very highly integrated with international capital markets, and some experts have therefore concluded that this lower interdependence between the two, together with the higher growth prospects of the developing countries, offer additional benefits to investors who diversify their portfolio in order to participate in the new markets. Moreover, since their investments in emerging markets represent only a very small fraction of their total portfolio, their exposure to exchange risks does not necessarily outweigh the favourable effects of such diversification. Moreover, emerging markets typically offer only limited information to the public, so that investors ready to spend money on the generation of information have a better chance of identifying undervalued shares with appreciation potential. Finally, the emerging markets are now being discovered by investors who traditionally concentrated their attention on the industrialized countries.

External investors also apparently see Latin American bonds as a relatively secure instrument. Firstly, during the crisis of the 1980s, the countries of the region continued to service the bonds they had

previously issued in a normal manner, and some experts have concluded from this that the bonds have *de facto* priority with regard to the availability of foreign exchange. Secondly, it is often maintained that bonds are less subject to non-payment than commercial loans, as it is a good deal easier for bondholders to initiate legal action (Gooptu, 1993).[24]

There were also regulatory factors at the international level which facilitated the entry of capital. One of the most important of these was probably rule 144A adopted in April 1990 by the Securities and Exchange Commission in the United States. This rule allowed institutional investors registered in the United States to buy and sell securities not registered with the Commission. This strengthened the "private market" for securities not registered in the United States, thus making it possible for Latin American enterprises to organize sales of ADRs and GDRs without having to adhere to the conditions imposed on the "public market" of registered securities (for example, the adoption of the United States system of book keeping).

Financial "engineering" has become the fashion in international markets, and the propensity to innovate has benefitted Latin America. Enterprises with a low market profile have been able to obtain financing thanks to the imaginative mechanism of offering special guarantees in cash; for example, some Mexican enterprises were able to issue bonds by using the backing of blocked funds, financed against future earnings of foreign exchange. Another technique used has been to offer bonds with option certificates or warrants; the Mexican firm *Nacional Financiera* S.N.C. recently made a US$ 100 million bond issue which gave investors the option, after the third year, to convert their bonds into shares in a State enterprise.

The popularity acquired by financial instruments such as ADRs also facilitated the flow of capital into the region, because they created a more favourable environment for external investors. On the one hand, dividends are received directly in dollars; on the other, the ADRs may be purchased with the cheaper credit available in the United States.

c) Sources and uses of the new external capital flows

As already noted, one of the main features of the recent boom in capital flows has been the relative marginalization of the commercial banks and the emergence of more diversified sources of financing than those of the 1970s. In particular, a more important role has been played by foreign direct investment (FDI) and portfolio investments (shares, bonds and other securities).

Naturally, the flows of FDI originate in decisions taken by transnational corporations, most of which are located in the industrialized countries, especially the United States, which has traditionally been the primary source of FDI (Calderón, 1993b). Although the industrialized countries are the main generators of these flows, however, intra-Latin American investments are showing increasing dynamism (Calderón, 1993c). During the two or three last years, for example, Chilean enterprises have become important foreign direct investors in Argentina.

Unfortunately, investments in securities, which are now one of the most important sources of financing, represent to a large extent anonymous transactions in which it is not easy to identify the investors.[25] Nevertheless, there is relatively general agreement that, in the beginning, the predominant source of portfolio fin-

24 This confidence appears to contradict historical experience, for in the 1930s prolonged cases of non-payment of the external debt occurred mainly in the case of bonds, which were then the main debt instruments. In the 1980s, in contrast, bonds represented only a minimal proportion of the total debt (ECLAC, 1964).

25 For example, bonds are usually payable "to bearer", while, investments in equity are also hard to trace unless there is an official requirement to register them.

ance was the repatriation of assets held by Latin American residents abroad (Gooptu, 1993). It is always difficult to estimate capital flight, because of problems of information and the existing disagreement on exactly what it consists of,[26] but orders of magnitude can be determined on the basis of approximate estimates. An estimate based on a methodology contained in a recent report of the World Bank (1993b) suggests that between 1988 and 1992 the return of flight capital was indeed a very significant source of external financing, even taking into account substantial errors of overestimation.

As already noted, there are various reasons which explain such repatriation. Firstly, residents are perhaps the best informed about developments in their own country, so that when problems arise they may be the first to "escape", and when the situation improves, the first to return. Clearly, the structural reforms and liberalization which have been carried out have increased the opportunities for obtaining profits and reduced the transaction costs of moving domestic financial resources into and out of the region. Another motive for repatriation has been the relatively high cost of domestic credit, together with the low profitability of external assets. The purchase of Latin American bonds (which are seen as having government support), of shares in specific country investment funds and of American Depositary Receipts (ADRs) have also given local residents a feeling of security against political risks and risks involved in the transfer of resources.

Although part of this repatriation is permanent, perhaps the prime motivation is speculative —to obtain high profitability over the short term (Gooptu, 1993). To the extent that this is true, this means that a large part of the region's external financing is highly volatile.

Other sources of financing are foreign individuals and enterprises who seek high-risk high-return investments. The main vehicles for this type of investment have been the managed funds specializing in the securities of emerging markets (bonds and shares) and in the retail purchase of international bonds and ADRs.

The most stable sources of portfolio financing are the big institutional investors, like insurance companies and pension funds. The institutional investors with the largest foreign portfolios are to be found in the United Kingdom, followed by Japan and the United States. However, their investments in emerging markets constitute a relatively marginal part of their portfolios, amounting to less than 5% of their total investments abroad. Even so, institutional investors seem to have been much more active in Latin America in 1992-1993, and certain information provided by market operators suggests that those organizations might continue to considerably increase their participation in the years to come (Gooptu, 1993). Finally, as regards the geographical origin of the portfolio flows towards Latin America, they appear to come largely from the United States, followed by Europe (especially the United Kingdom) (Howell, 1993).

As regards the use made of the new external financing, relatively little information is available. One thing is clear, however: it is the Latin American private sector which mobilizes the bulk of the portfolio investment. Naturally, most of the capital investment —in shares or direct— is mobilized by private enterprises. But the private sector has also predominated in bond issues: in 1992 and 1993 private bodies accounted for 70% and 55%, respectively, of the total value of new bonds (World Bank, 1993a).

4. The quality and future prospects of the new financing flows

One of the problems in evaluating the current increase in the flow of capital is the relatively limited nature of the informa-

26 For an analysis of the problems of estimating capital flight and a presentation of the different estimates, see Lessard and Williamson (1985).

Table IX.18
LATIN AMERICA (SELECTED COUNTRIES): FOREIGN CURRENCY DEPOSITS
(Percentages)

	Deposits in foreign currency/M2			Deposits in foreign currency/GDP		
	1990	1991	1992[a]	1990	1991	1992[a]
Argentina	32.1	57.6	66.2	5.1	9.8	14.7
Chile	16.0	14.4	9.1	5.8	7.0	5.4
Costa Rica	32.0	38.6	31.2	11.9	15.5	14.4
Mexico	20.2	18.6	15.0	5.2	6.7	6.1
Paraguay	26.4	29.7	32.8	3.9	4.0	5.3
Peru	54.5	58.0	63.6	3.1	7.1	8.6
Uruguay	554.2	527.6	490.6	55.6	61.5	57.4

Source: ECLAC, on the basis of official figures.
[a] Preliminary figures.

tion available. There is no single complete source of data on the different components of capital flows. The large quantity of local deposits in United States dollars (see table IX.18) and local-currency government securities acquired with dollars (such as the Treasury Certificates (CETES) issued in Mexico) represent potential foreign-currency obligations which do not appear in the external debt figures. Meanwhile the most general estimates of flows and obligations are full of chronological anomalies, while the various public and private efforts to collect information do not necessarily generate compatible estimates. A similar situation prevailed in the 1970s with regard to bank loans to the developing countries, and this lack of information may have contributed to the excessive granting of loans, the overindebtedness and crisis.[27]

In spite of these limitations, a brief assessment of the new capital flows is given below.

a) Terms and costs

A relatively large proportion of the new flows of external financing seem to be on relatively burdensome terms, with a significant proportion of short-term maturities. As may be seen in table IX.4, in 1992 almost a third of the net capital flow was short-term: i.e., with a maturity of one year or less. Another quarter was in the form of portfolio investment, which has quite short terms or can be liquidated (albeit perhaps at a loss) quite rapidly.

Bonds —considered as one of the most rapidly growing of the new financial flows— have formally had a medium-term maturities, but in the 1990s this means three to five years. This limited horizon compels borrowers to have frequent recourse to difficult and uncertain refinancing exercises. The present situation contrasts with the past century when developing countries could attract capital by issuing bonds with terms of up to 99 years (Hughes, 1979). Even the commercial banks offered average terms of seven to eight years in the 1970s. If Latin America can maintain access to these bond markets, and if more institutional investors participate, the terms might be extended. Stock exchange investment, for its part, carries no commitments as regards terms and can

27 Indeed, creditors only became aware of the growing debt problem at quite a late stage.

be withdrawn without prior notice.[28] FDI, however, which made up almost a third of the net flows in 1992, is a long-term commitment.

All the new sources of finance are relatively burdensome. Such is the case of bonds and FDI; but it is also true in general of financing based on paper issue (Williamson, 1993a). This is one of the reasons why stock exchange investment in new shares is not usually an important source of new capital.[29] Naturally, the high cost is not in itself a problem if the resources are used in activities with even higher profitability and if the global economy can generate enough foreign exchange to service the external capital. Unfortunately, there is little microeconomic information on the manner in which external financing is used; however, at the macroeconomic level it is possible to examine the association between changes in external financing and domestic use of the resources for consumption or investment. This question is explored in chapter XI.

b) Volatility

As already stated, an important source of capital has been the repatriation of funds by residents and the entry of foreign capital for short-term speculation in Latin America. The profits from such speculation are currently quite high, partly because of the international recession and the low international real interest rates in the North. Naturally, any substantial variation in short-term profitability in Latin America compared with the rest of the world may reverse the direction of the capital flow, with negative consequences for the balance of payments and external adjustment. The speculative nature of these flows makes them potentially unstable.

Another perspective from which to judge volatility is to examine the standard deviation of the flows in the capital account of the balance of payments by major types of transactions. This is the procedure used in table IX.19 for Latin America as a whole and six relatively large countries of the region. From this table we can see that the short-term financial flows (i.e., those with terms of less than one year) have traditionally been highly volatile in the last 40 years.[30] This characteristic may have had relatively little impact on the region in the expansionary international financial cycles of earlier days, since short-term flows usually represented only 10% to 15% of the total net financing. In the 1990s, however, short-term capital flows have played a very important role: 29% of the total in 1992 and 58% in 1991. This suggests that the region may be facing a new risk of vulnerability in its balance of payments.

In contrast with short-term capital, in general long-term flows have shown much less volatility over the last 40 years. This category includes some portfolio flows, such as bonds. Up to the 1990s, however, the magnitude of this type of financing was so small that evaluations of its historical volatility are of no great significance. Also, the "loans" category has shown a relatively low degree of volatility over the period since the war. Unfortunately, however, in the 1990s this type of flow has not been very dynamic, partly because of the variability of the international strategies of the commercial banks.

Another long-term flow is foreign direct investment (FDI). This balance of payments category also has relatively low volatility. FDI is usually touted as a very attractive source of external financing, which is claimed not only to be relatively permanent but also to incorporate technol-

28 Naturally, there must be a domestic buyer. This question will be examined later.

29 In the United States, stock exchange investment is only 7% of new gross investment, and in the developing countries it is much lower (Welch, 1993). Traditionally, the main role of stock markets has not been to encourage new investments, but rather to offer liquidity to investors.

30 This is clear from the very high standard deviations for the category "short-term" flows of the balance of payments for the period 1950-1992. These standard deviations are comparable, since they were standardized by the average for each sub-period.

Table IX.19

LATIN AMERICA (SELECTED COUNTRIES): VOLATILITY OF EXTERNAL CAPITAL FLOWS

(Coefficient of volatility) [a]

Net capital movements	1950-1959	1960-1969	1970-1979	1980-1989	1990-1992	1950-1992	1980-1992
Latin America							
Long-term	0.63	0.45	0.62	0.88	1.10	1.38	0.87
–Loans	0.69	0.42	0.63	1.25	3.12	2.00	1.90
–Foreign direct investment	0.77	0.58	0.61	0.34	0.36	1.09	0.40
Short-term	3.40	2.20	1.76	3.63	0.69	31.30	16.20
Grants and donations	0.70	0.16	0.44	0.43	1.73	1.45	0.72
Errors and ommissions	1.39	1.80	4.10	1.45	5.98	3.50	1.80
Argentina							
Long-term	1.50	3.10	1.60	0.80	0.69	1.80	0.76
–Loans	2.60	22.10	1.60	1.10	1.80	2.80	1.70
–Foreign direct investment	1.50	1.60	1.50	0.68	0.95	1.90	0.98
Short-term	3.70	2.90	39.70	2.10	2.30	5.60	2.70
Grants and donations	2.50	2.60	2.90	-	-	6.20	-
Errors and ommissions	19.60	3.60	2.70	2.20	3.10	6.10	2.70
Brazil							
Long-term	0.67	0.48	0.50	1.10	2.20	1.51	1.28
–Loans	1.39	0.80	0.60	1.50	3.70	1.80	1.70
–Foreign direct investment	0.50	0.30	0.50	0.52	1.40	1.00	0.60
Short-term	6.70	2.30	1.30	4.80	2.10	4.30	3.30
Grants and donations	0.50	0.40	1.50	5.20	-	1.50	3.70
Errors and ommissions	3.30	1.60	3.00	1.00	0.70	3.20	0.80
Chile							
Long-term	1.00	0.52	1.80	0.80	0.38	1.56	0.72
–Loans	1.60	0.39	1.40	1.40	0.47	2.00	1.30
–Foreign direct investment	1.30	2.40	9.20	0.65	0.41	2.20	0.70
Short-term	15.40	1.60	1.16	4.20	1.00	3.89	2.40
Grants and donations	1.20	1.20	0.62	0.56	0.43	1.85	0.92
Errors and ommissions	3.80	3.00	2.00	5.00	43.60	8.20	7.90
Colombia							
Long-term	1.20	0.76	0.69	0.53	0.38	1.48	0.73
–Loans	1.30	0.80	0.75	0.68	0.18	1.70	1.00
–Foreign direct investment	2.50	0.76	0.63	0.64	0.07	1.60	0.58
Short-term	13.20	3.20	27.60	3.70	1.10	5.70	2.57
Grants and donations	0.93	0.82	0.54	11.20	0.20	1.80	2.97
Errors and ommissions	2.00	7.80	0.86	2.20	0.75	46.10	5.16
Mexico							
Long-term	0.40	0.57	0.62	1.12	0.56	1.67	0.98
–Loans	1.02	0.74	0.67	2.28	1.20	2.05	1.53
–Foreign direct investment	0.29	0.58	0.51	0.58	0.50	1.42	0.72
Short-term	2.20	4.49	7.49	2.53	0.43	16.90	10.80
Grants and donations	1.35	1.39	0.42	1.13	1.14	2.30	1.36
Errors and ommissions	3.20	8.70	2.60	2.29	3.70	3.84	2.40
Mexico							
Long-term	1.58	5.58	1.59	25.70	0.81	3.41	4.60
–Loans	2.45	7.00	1.41	2.56	1.80	10.20	2.90
–Foreign direct investment	1.55	6.00	3.60	1.08	0.76	4.60	1.24
Short-term	12.40	2.88	19.30	1.46	2.30	3.20	1.55
Grants and donations	0.46	1.25	0.84	0.16	0.26	1.21	0.25
Errors and ommissions	1.20	2.00	1.56	3.30	0.62	8.80	2.10

Source: ECLAC, on the basis of official information.

[a] Standard deviation, weighted by the average for the period.

ogy and know-how. Supposedly, it also follows an anticyclical trend in the sense that profits are sensitive to the ups and downs of domestic economic activity.

However, an examination of FDI trends in Latin America suggests that a few warnings are in order regarding the anticyclical nature of this type of flow. According to preliminary statistical analyses, the correlation coefficients tend to suggest that net transfers of FDI have been positively associated with the direction of the global external transfer of resources and with the behaviour of the export sector and the levels of reserves. Hence, it could be worth going more deeply into the hypothesis that the financial behaviour of FDI is procyclical in the face of balance-of-payments trends. If this is so, it may be that its financial effects on the external sector are not all that favourable.

As regards external capital on the Latin American stock exchanges, it should be noted that it cannot be withdrawn unilaterally: in order to sell part of it, there must be a buyer to act as a counterpart. Hence, massive withdrawal from these markets can only be achieved at the cost of a violent price drop. For this reason, some maintain that it is improbable that external capital trends on the stock exchanges could be suddenly reversed. However, the financial influence of investors and externalities on the stock exchanges is so great that we must not underestimate the risks of possible stampedes by foreign investors and systemic crises, for events on the stock or foreign exchange markets may induce a massive liquidation movement in an attempt to cut losses sustained as a result of additional price declines.[31]

c) Future access

We can only guess as to whether Latin America will further extend and develop its present advantageous position on the international capital markets. However, there are reasons to be optimistic: for example, there are certain indications that in the 1990s portfolio investors "discovered" emerging markets in the developing countries (Howell, 1993). If the only thing motivating them were high profitability, this might simply be a passing interest, but apparently there has been a growing interest in gaining the supposed benefits derived from the diversification of portfolios towards those financial markets whose behaviour is not closely correlated with that of markets in the industrialized countries. This latter motive is more structural and permanent. Moreover, the external portfolio of the investors is enormous. For example, at the end of 1992 international investors held US$ 900 billion in foreign securities alone (Howell, 1993), and only a tiny fraction of this sum is currently assigned to the emerging markets. Consequently, even a small diversification towards those markets could bring a huge flood of resources to the developing areas, and to Latin America in particular.[32]

Another factor that must be borne in mind on the supply side is that the capital holdings maintained abroad by Latin American residents are apparently very considerable. Kuczynski (1992), for example, estimates that Latin Americans have some US$ 300 billion deposited abroad.[33] Nor can we discount the possibility that the favourable demonstration effects generated by the profits obtained by foreign investors may renew the interest of banks in extending medium-term

31 Hence the importance of internal regulation, which is dealt with in chapter XII.

32 The pension funds of the United Kingdom have increased their investments in foreign securities from 6% of their assets in 1989 to 18% in 1990, and if 5% of these investments were placed in emerging markets, this would still represent only 1% of their total assets. The figure for United States pension funds is much lower. In contrast, at the beginning of the century portfolio investors held up to 50% of their investments in the emerging markets (Howell, 1993).

33 Naturally, not all these funds would be available for repatriation, for they may include significant amounts of semi-permanent investments abroad.

loans to developing areas. At the same time, economic growth, added to transparent and attractive investment rules, should continue to attract foreign direct investment.

But as pointed out by Williamson (1993a), in the Latin American economy we should not equate access to external financing with success, for on quite a few occasions the region has had access to abundant external financing —the last episode was in the 1970s— only to end up in crisis. Clearly, continued presence in these markets will depend not only on good incentives for investors but also, in more general terms, on prudent economic management, including the extent to which the volume, type and use of external financing are compatible with macroeconomic stability, international competitiveness and a strong domestic process of saving and investment. The external capital markets are usually less disciplined than the textbooks and market operators like to make out, and they are clearly prone to adopt prevailing cyclical trends and to make adjustments which create unsustainable financial booms. Moreover, the volume of resources available at a given moment may be enormous, compared with the productive and absorptive capacity of any developing country. Consequently, in times of abundance special discipline is required, and it would be a good thing if this came from the borrowers, rather than trusting exclusively in the "judgement of the market" or of the creditors.

Chapter X

CAPITAL MOVEMENTS AND DEVELOPMENT: THE ANALYTICAL FRAMEWORK

From both the theoretical and the practical standpoint, external financial inflows can be a valuable complement to domestic efforts to initiate and sustain development processes. This chapter examines the relationship between capital inflows and the need for macroeconomic stability, growth and development.

Section 1 discusses a number of theoretical arguments, both traditional and relatively new, which analyse the role played by external capital mobility in development processes. Section 2 presents a brief description of the ongoing debate on the dynamics of capital account liberalization. What is attempted here is not to make a detailed study of the literature on these topics,[34] but rather to review the development of some of the main ideas and policies on capital mobility. This will provide useful background information which, together with the discussion of the composition and volume of capital flows in the previous chapter, will make it easier to analyse the relevant public policies in the region.

1. The role of external capital mobility in development

External capital flows have long been assigned an important role in development. Moreover, in recent years increasing attention has been given to the issue of capital mobility and its impact on development. Here, six central roles for international capital mobility are identified: a) improved macroeconomic resource allocation; b) mobilization of foreign savings; c) smoothing out of expenditure over time; d) risk diversification; e) micro-productive efficiency and f) enhanced credibility of the monetary authorities. Each of these roles is backed up by powerful theoretical arguments. However, it also will be shown that the real second-best world in which we live can run counter to many of the textbook appreciations of capital flows. This has given rise to certain caveats about the role of capital mobility in the development processes, the most important of which are also outlined in this section.

a) Efficient resource allocation

At the aggregate level, capital movements are supposed to improve the efficiency of world resource allocation (Mathieson and Rojas-Suárez, 1993), for real returns on marginal investment in capital-rich countries are typically lower than those in capital-scarce countries. With capital mobility, savers in the capital-rich country may be expected to give up their lower-yielding investments at home for higher-yielding investments in the poorer country. Thus, savers in the rich country earn a higher rate of return on

34 For a good recent study, see Hanson (1992).

their capital, while domestic investment and national income of the capital-poor country increase. The improved world resource allocation is also gradually reflected in smaller differentials in yields on investment between the two countries.

Like many theoretical arguments, the predicted outcomes depend on compliance with some strict conditions. Among these is the condition that financial markets, which intermediate most international movements of capital, must have what Tobin (1984) terms fundamental valuation efficiency: i.e., market valuations must accurately reflect the updated value of the dividends that the assets in question can be reasonably expected to generate over time. Accurate pricing is extremely important because prices are the main signal for the market's reallocation of capital. Unfortunately, price movements in financial markets often do not reflect fundamentals (Tobin, 1984; Stiglitz, 1993; Kenen, 1993). Moreover, those investments which attract cross-border capital flows owing to their higher expected private returns may not necessarily be the investments with the highest social rate of return.

Thus, empirical studies (summarized in Tobin, 1984; Akyüz, 1993; Lessard, 1991) as well as historical analyses (Kindleberger, 1978) suggest that serious inefficiencies can arise from the allocative mechanisms of capital markets. Indeed, under conditions of capital market imperfections, together with non-economic factors, almost anything can happen regarding the conjunctural flow of capital. In sum, there is no reason to assume *a priori* that capital movements will necessarily improve world resource allocation.

In the long run, the process of trial and error allows market agents to get a better idea of the prevailing distortions and imperfections, so that, over time, unencumbered international financial markets can systematically allocate capital more efficiently.[35] However, in the short term the imperfections in question can cause financial markets to allocate too much or too little capital (*vis-à-vis* the underlying returns) to some recipients at a given moment. The risk of such misallocation rises in proportion as flows are directed to purely financial operations rather than to productive investment and trade. When the short-term misallocation is very large or systemic, it can induce a crisis and have devastating consequences for firms, economic sectors and nations. Moreover, these short-term disturbances in finance, which seriously disrupt output and distort returns to capital, can obviously impart arbitrary advantages and disadvantages to different economic agents, which in themselves can become determinants of returns and thus of international resource allocation trends.

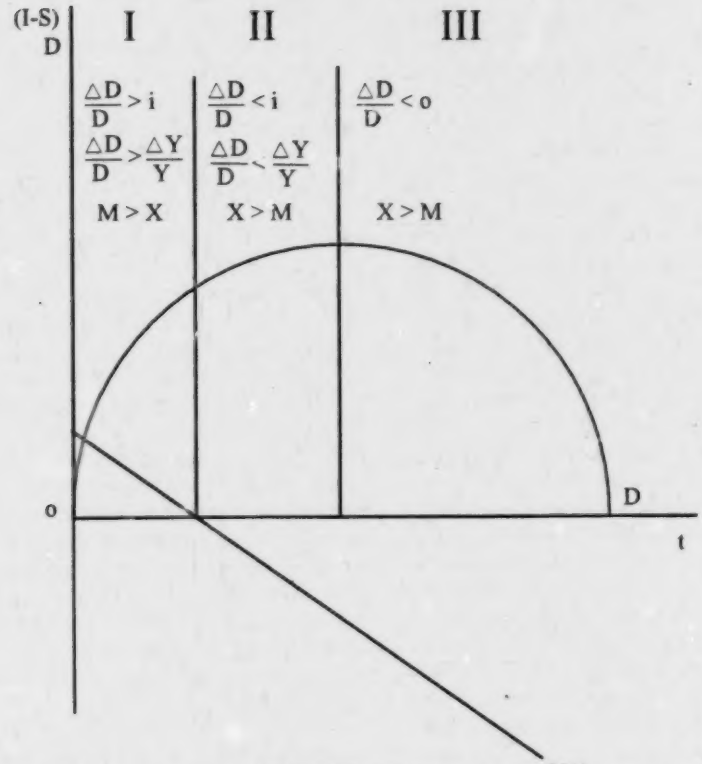
b) Mobilization of external savings

This has been perhaps the most traditional, and certainly the strongest, argument in favour of international capital mobility and flows to developing countries, for in developing countries capital is usually the scarcest factor of production, while relatively low incomes and domestic savings hinder rapid capital accumulation and growth. Therefore, external savings in the form of net capital inflows can supplement domestic savings, raise investment levels and boost growth. In turn, expansion of aggregate income can further raise domestic savings and investment, thereby creating the basis for sustained economic expansion.

The "virtuous cycle" is usually seen in terms of the favourable long-term external resource cycle shown in figure X.1. During period I, foreign capital (for the sake of simplicity represented exclusively in the form of debt) finances the shortfall in savings. External saving has its counterpart in a deficit on the country's trade account. In this initial period foreign debt grows very rapidly —faster than GDP— because new loans must not only cover the savings gap

35 Indeed, Bloomfield (1968) concluded that free international mobility of capital in the 19th century resulted in capital migrating to the places with the highest rates of return.

Figure X.1
A VIRTUOUS DEBT CYCLE



I	=	Aggregate investment
X	=	Exports
S	=	Domestic savings
M	=	Imports
D	=	External debt
N	=	I - S
Y	=	GDP
t	=	Time
i	=	Interest rate

but must also refinance all the debt service falling due. However, economic growth progressively raises the proportion of targeted investment that can be financed from domestic savings, until a point is reached at the end of period I, where the country's savings level is high enough to finance all its investment and trade balance is reached. Interest payments are still, however, covered with new debt.

In period II, continued economic growth generates a surplus of domestic savings with respect to targeted investment levels and this manifests itself in the emergence of a trade surplus, which permits the country to voluntarily begin to reduce the resource transfer from abroad by paying progressively greater proportions of the interest on its foreign debt. Consequently, the rate of growth of the debt gradually declines to less than that of GDP, and the debt stops growing altogether at the end of period II, when the savings (and trade) surplus rises to a level large

enough to cover all interest on foreign liabilities. In period III, economic growth and the continued expansion of the domestic savings surplus permit the country not only to pay all its interest commitments, but also to begin paying off the foreign debt until it falls to zero. After this, the country's virtuous credit cycle culminates in its graduation to the club of countries which are net capital exporters.

While obviously highly stylized, this traditional parable has some powerful messages. First, external capital flows should consistently go to augment aggregate investment, and not be diverted to consumption. Second, an aggressive domestic savings effort is called for: from the outset of the cycle, the marginal savings rate must be kept at a level which is much higher than the country's average savings rate and also considerably greater than the investment rate, thus eventually permitting a savings surplus to emerge. Third, the investment must be efficient. Fourth, the country must aggressively invest in tradable goods, exports and import substitutes, in order to be able to create a trade surplus large enough to transform domestic savings into convertible currency, so as to service the debt in stage II and pay it off completely in stage III.[36] Fifth, it requires well-informed, and patient, creditors who are willing to provide stable and predictable flows of finance on reasonable terms, especially in the delicate stage of period I, when debt service must be completely rolled over by the creditors and a positive transfer of resources must be sustained for a considerable number of years.

These strict stylized conditions may not all be complied with in practice, of course: countries may experience an ongoing substitution of domestic savings by foreign savings; investments may not always be efficient or channeled sufficiently into tradable goods, and creditor behaviour may be perverse. Indeed, convincing though the traditional argument for the transfer of international savings to relatively poorer countries may be, the above problems have often caused this valuable developmental mechanism to operate only feebly. It may be recalled, for example, that between the Great Depression and 1965, relatively little capital flowed to developing regions. Moreover, when flows were renewed in the 1970s, the outcome for a large number of countries was a glut of finance which contributed to the crisis. Notwithstanding these serious difficulties, however, foreign savings have historically played a significant role in the development of many countries, with some, like the United States, emerging as industrialized nations and subsequently evolving into major capital exporters.

Latin American countries have long used foreign savings to promote development and growth. Latin America's history as regards external financial flows has been chequered, however, as countries have repeatedly entered into defaults and crisis either due to imprudent deployment of foreign resources, destabilizing creditor behaviour or adverse external shocks (ECLAC, 1964; Stallings, 1987). The most recent crisis was of course the devastating debt problem of the 1980s.

Table X.1 shows the importance of external savings in aggregate investment flows in the region since 1970. As may be seen, if the crisis years of 1983-1989 are excluded, then for the region as a whole external savings have financed only about 15% of aggregate investment. It should be noted that this average masks the much greater significance for foreign savings for Central America and the Caribbean, where their contribution to investment is a third or more. This relatively high participation of foreign savings, which confirms the rather special situation of that subregion, is due in part to the importance of official donations, which unlike most foreign savings do not involve a direct servicing burden.

36 If the government is the main debtor, a fiscal surplus must also be generated, implying some combination of increased taxes and lower expenditure. For an analytical framework, see Eyzaguirre (1989).

Table X.1
LATIN AMERICA AND THE CARIBBEAN: EXTERNAL SAVINGS AS A PERCENTAGE OF TOTAL INVESTMENT [a]
(Percentages)

	1970-1975	1976-1982	1983-1989	1990-1992
Latin America and the Caribbean	13.5	17.3	5.9	12.0
Petroleum exporters	9.8	14.3	1.3	15.9
Non-petroleum exporters	16.2	19.9	9.5	7.8
South America	15.1	18.8	7.3	3.7
Central America and the Caribbean	31.1	35.5	36.7	51.1

Source: ECLAC, on the basis of official data.
[a] External saving is the deficit on the current account of the balance of payments. Investment is gross capital formation. The data are in 1980 dollars.

At all events, it is clear that domestic savings account for the bulk of investment, even in Central America and the Caribbean. Clearly, without a sustained effort on this front, the investment process will fall short of what is needed for sustained growth. Thus, foreign savings only complement this domestic effort.

c) Smoothing-out of expenditure over time

There are some possible scenarios where external capital inflows can reduce the costs of intertemporal differences between production (or income) and expenditure. Whereas the previous arguments focused on long-standing movements of capital, this one is more oriented towards conjunctural trends.

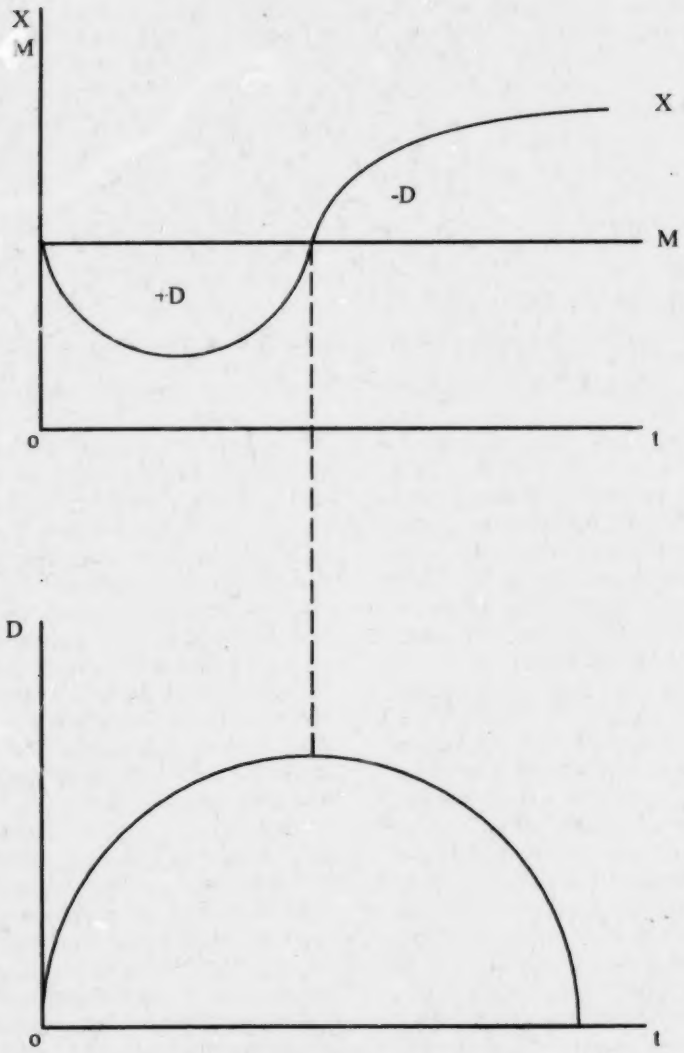
The simplest example of this role of external capital is shown in figure X.2, where a country experiences in the first half of every year a sharp and predictable seasonal drop in the output of its principal export commodity. Even if it had no reserves to draw upon, it could sustain a constant capacity to import by compensating the period of low export earnings through external borrowing and then repaying the loans in the period when export earnings rise to their seasonal peak, thus leaving the country with no net debt. In this way, at the cost of the interest payments on the debt, the country avoids the social disruption of adjusting its domestic expenditure to the fluctuations in the output of its principal export commodity.

Developing countries may also confront very protracted shocks and loss of income. In this case external financing can smooth the inevitable adjustment process and even allow the country to keep up its domestic expenditure (and import capacity) while resources are reallocated to new productive activities.

For instance, a world-wide technological change may suddenly adversely affect external demand and production in a major exporting sector, causing aggregate exports, output and income to fall. Obviously, the country must adjust and reallocate its now idle domestic resources to new productive export activities if it is to regain its pre-crisis level of output and restore balance in the external accounts. By making use of external borrowing, however, the country could keep up its pre-crisis rate of expenditure (and import capacity) until the new activities' output and exports come on stream: an inevitably lengthy process.

Indeed, thanks to capital flows the growth of domestic expenditure can be

Figure X.2
COMPENSATORY INDEBTEDNESS



X	=	Exports
Y	=	GDP
M	=	Imports
E	=	Aggregate expenditure
D	=	External debt
t	=	Time

maintained at or near the old levels during the adjustment period with a concomitant external deficit and rise in foreign debt. While this policy does not eliminate all the costs of adjustment, it does minimize the under-utilization of productive resources and the social disruption caused, by allowing the inevitable costs to be spread out over time, although when the fruits of adjustment produce new exports and there is a recovery in the growth of output, the rate of expansion of aggregate expenditure must be restrained so that a domestic surplus (i.e., negative foreign savings) emerges to repay the foreign debt.

If the shock were basically transitory (for example, a temporary rise in international interest rates or a conjunctural worsening of the terms of trade), the country could borrow foreign resources to sustain expenditure. In this case, no adjustment would be necessary, but here too there is a cost similar to the above: in order to service the debt and repay it in the future, aggregate expenditure must be kept below aggregate output for a certain period of time.

While capital mobility can theoretically help to spread out over time the costs of intertemporal differences between output and expenditure, the process may not always evolve smoothly in practice. If the transitory swings in external variables —like the volume of exports, the terms of trade, or interest rates— are entirely predictable, free capital markets could conceivably provide the desired finance without much difficulty. But in developing countries it is not always easy to ascertain whether a downturn in the external sector is transitory or not, and this uncertainty, coupled with imperfections in international capital markets (especially their shortsightedness or relatively narrow time horizons), the relatively large impact that even small external shocks can have on poor developing economies, and the less than perfect policy responses that can emerge, all represent obstacles to the arrival of adequate amounts of external finance. Moreover, in the face of a protracted shock, where creditworthiness depends on the ability and uncertain willingness of the country to adjust, the mobilization of adequate non-compensatory finance may be very problematical indeed. In these circumstances official compensatory finance —e.g., from the IMF— could fill the financing gaps that might emerge. However, here the record shows that in this respect there are serious imperfections owing to the mechanical limits on the availability of multilateral funds to each borrower and the only modest overall financial power of the official lenders (O'Connell, 1993).

When this valuable role of international capital mobility is played only imperfectly, the costs of adjustment for developing countries can be enormous. That is because in the face of a negative external shock (and limited domestic international reserves), any shortfalls in capital inflows will require immediate cutbacks in domestic expenditure to restore the external balance. Moreover, while in theory output need not necessarily fall during this adjustment of expenditure, it almost certainly will in practice because of the natural rigidities standing in the way of resource reallocation, while there also tends to be a disproportionate cutback in investment. Latin America's external adjustment in the 1980s illustrates this point very well: much higher interest costs on the foreign debt and deterioration in the terms of trade, coupled with a severe shortage of financing, forced a massive adjustment of domestic expenditure. At the same time, resource rigidities and serious contractions in the supply of imported inputs and investment contributed to unprecedented losses of output from which many countries still have not recovered (ECLAC, 1984a; Ramos, 1985; Ground, 1986; Feinberg and Ffrench-Davis, 1988).

d) Diversification of risks

If finance is treated analogously to goods, social benefits could be perceived in a two-way international trade in financial assets, since capital mobility would allow individuals to satisfy their risk preferences more fully through greater diversification of their asset holdings. As

Hanson (1992) emphasizes, this social benefit arises even if capital mobility has no effect whatsoever on the savings and investment process.

Following the analogy of trade in goods, this relatively recent idea concerning the benefits of capital mobility leads logically to the recommendation of free trade in financial assets (Mathieson and Rojas-Suárez, 1993). Indeed, this is one of the most widely-used arguments for justifying international across-the-board capital mobility. The conclusions are based on the notion of an integrated world economy where total well-being is the sum of the well-being of individual investors.

The strength of the general argument is weakened, however, when one breaks with the analytical tradition of the representative agent and the unit of analysis used is the country, some of them net debtors and others net creditors. In the first place, it is an individual's desire for diversification through capital outflows that initiates the trade in financial assets, and in the final analysis the main benefits from free trade in financial assets will go to those countries which are net capital exporters rather than those which are net importers of capital, as is usually the case in developing regions (Williamson, 1983). In the second place, during the process of equalization of interest rates, an unregulated situation could degenerate into big imbalances owing to the excessive proliferation of investors with speculative instincts, who, it is well known, can lead to a weakening of the savings-investment process, which is of course of central importance to a developing country. High-risk transactions are known to be inherently more unstable, and when their volume is substantial they can cause the economy to adjust to prices which will not prevail in the medium term. These phenomena could weaken the solvency of financial systems, raise the interest cost to borrowers, deter investment in tradable goods, and develop into speculative bubbles which end in a crisis.[37]

In fact, the analogy between free trade in goods and free trade in financial assets may be mistaken. Trading in international financial assets is not identical to, for example, cross-border trade of wheat for textiles (Díaz-Alejandro, 1985; Devlin, 1989). The latter transaction is complete and instantaneous, whereas trade in financial instruments is inherently incomplete and of uncertain value, since it is based on a promise to pay in the future. In a world of uncertainty, incomplete or underdeveloped insurance markets, informational costs and other distortions, ex ante and ex post valuations of financial assets may be radically different. Moreover, the separation in time between a financial transaction and payment for it, coupled with informational barriers, generates externalities in market transactions that can magnify and multiply errors in subjective valuations to the point where finally the market corrections are very abrupt and destabilizing. It is precisely because of this that well-being may decline with deregulation of trade in financial assets and rise with a certain amount of increased public intervention (Stiglitz, 1993). Thus, public control of trade in certain financial assets might reduce some individuals' well-being, but at the same time it would increase national or aggregate well-being through the enhancement of macroeconomic stability and better investment performance.

Finally, the separation in time between a financial transaction and the payment for it, with the consequent risk of default, also leads to efficiency criteria which are different from those found in the markets for

37 Indeed, significant speculative bubbles arose in Argentina, Chile and Uruguay in the 1970s and early 1980s. Domestic interest rates and the value of domestic financial assets grew considerably faster than output and income, and remained above the levels observed in international financial markets. Financial bubbles were basically the result of four factors: i) relatively fast, radical liberalization of domestic financial markets; ii) a permissive or non-existent domestic regulatory system; iii) heavy capital inflows, mainly resulting from the liberalization of the capital account and the big interest rate spread; and iv) the corresponding exchange rate lag caused by these flows.

goods and services, which clear themselves naturally through prices. In contrast, many financial markets do not clear through prices, as informational, monitoring and enforcement problems related to the borrower's behaviour cause efficient creditors to ration the volume of finance in practice.[38]

e) Micro-efficiency of production

International capital mobility is also supposed to improve productive efficiency at the micro-economic level. For the financial system this would imply lower intermediation spreads between lender and borrower (Akyüz, 1993). Generally, however, productive efficiency must also involve lower interest costs; this increases the average quality, or creditworthiness, of applicants for funds in the capital market (Stiglitz, 1993). Lower interest rates also raise the capital value of non-financial firms and stimulate their investment processes.

Since inflows of external funds compete with domestic capital, it may be expected that capital mobility will lower domestic interest rates. In addition, it can raise the number of effective intermediaries working in the market —including foreigners— which encourages financial innovations and puts downward pressure on intermediation spreads. The lower financial costs and the more intensive monitoring of borrowers (assuming that international investors are initially more sophisticated than their counterparts in a developing country) could also, of course, be conducive to greater efficiency in non-financial enterprises.

If the increased external capital is not allocated properly, or promotes greater volatility of asset prices, however, the mean result could be persistently high real domestic interest rates and spreads even in the face of massive capital inflows. High interest costs deteriorate loan portfolios and erode the capital value of firms as well as their savings/investment processes (Akyüz, 1993). Indeed, all these problems were present during the upward credit cycle in Latin America in the 1970s, particularly in those countries that indiscriminately encouraged unrestricted flows of external loans (Ramos, 1986).

Some regulation of competition may therefore be desirable, especially if financial market stability and predictable, stable access to finance help to reduce the perceived risks of long-term investment. This is one reason why many industrialized countries have been willing to sacrifice some degree of competition for the sake of tight regulation and stability in financial markets.[39]

f) Credibility of the monetary authorities

Some authors view capital mobility as a key ingredient in policies designed to give credibility to the monetary authorities, especially when that credibility has been lost owing to serious outbreaks of inflation. In its most conventional form, this analytical framework (often termed the monetary approach to the balance of payments) assumes open and internationally integrated trade and capital accounts, in conjunction with a fixed nominal exchange rate. The important thing, however, is that in the context of this overall scheme the economic agents should perceive that the existence of full convertibility and capital mobility takes away the ability of the country's authorities to manage the money supply: in other words, the money supply becomes just another endogenous variable of the economy. Conse-

38 This rationing occurs due to fears of "adverse selection", i.e., at some point a higher interest rate will attract only the market's riskiest borrowers, causing an overall deterioration in the expected value of the creditors' loan portfolio. Thus an efficient creditor will not necessarily offer loans to the highest bidder, as would occur in fragmented goods markets. For more on this see Jaffee and Russell (1976) and Stiglitz and Weiss (1981).

39 European countries (except the United Kingdom) tend to follow this pattern (*The Economist*, 1993a). In contrast, the United States has probably one of the most competitive financial markets, but it also has one of the highest rates of failure of financial institutions (Stiglitz, 1993).

quently, the economic agents will anticipate that inflation will converge to international levels. On the one hand, the announcement of a fixed exchange rate favourably affects inflationary expectations, because it signals a commitment to an anti-inflationary policy, while on the other hand, arbitrage of goods and financial assets may be expected to push domestic prices down towards international levels.[40]

In this approach, the monetary authorities' credibility supposedly rises not because of what they can do but rather of what they cannot do. In effect, they attempt to overcome a reputation for monetary indiscipline (and inflation) by renouncing monetary policy altogether: owing to the existence of capital mobility, their actions cannot affect the level of the money supply, which will adjust "automatically" to the real demand for money through changes in interest rates and balance-of-payments transactions which alter the amount of the international reserves.[41]

This theoretical approach has been controversial and has generated much debate (Ardito Barletta, Blejer and Landau, 1983). On the one hand, its theoretical conclusions are weakened when international arbitrage suffers from serious imperfections, as is usually the case in developing countries. Even with radical trade liberalization, goods arbitrage can be hindered by market segmentation and product differentiation, collusion and monopolistic distribution systems, and high transport and finance costs. Moreover, the opening up of trade will not stabilize all prices, as non-tradable goods can (at least for some time) find their price level with some degree of independence, and wages can also rise. Meanwhile, an open capital account in and of itself will not convert risk-adverse investors into risk-neutral investors, so that domestic and foreign assets will not necessarily be perfect substitutes for each other (Kenen, 1993; Dornbusch, 1983). The result is that the monetary authorities will still have some impact on the money supply, and the "single price law" will be imposed only slowly. As a consequence, there can be real exchange rate appreciation and financial crisis. Indeed, all these problems emerged in the Latin American countries which tried to use the monetary approach to stabilize prices in the late 1970s (Ramos, 1986).

Whatever its theoretical merits, the monetary approach has important detractors; as Peter Kenen (1993) has remarked, it is clearly a "high-risk strategy" because "no sensible sailor throws out an anchor before the boat stops moving". Indeed, instead of trying to attack inflation indirectly through the complex channels of an exchange rate commitment, many experts are of the opinion that it is more efficient to use direct fiscal, monetary and institutional reforms for that task.[42]

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40 For a more detailed overview of the monetary approach, see Blejer (1983).

41 This approach focuses basically on the changes in reserves rather than on the internal components of the current account of the balance of payments. This is because if the fiscal accounts are in balance, movements in the reserves are assumed to reflect private agents' demand for money.

42 It has also been argued that capital mobility can increase the credibility of the fiscal authorities. In effect, when an economy is closed, it is easier for governments to arbitrarily tax its citizens, either directly or via inflation. Potential taxes also cause foreign investors to raise their risk premiums. Since many taxes, but especially the inflation tax, are considered distortionary, it has been argued that well-being could be increased by permitting greater capital mobility; in this way, citizens could escape the taxes at low cost and society would benefit (Hanson 1992). Moreover, the authorities would be bound in the future to keep the tax burden at internationally acceptable levels. Capital mobility can certainly erode governments' ability to tax, especially today when there are few countries with bilateral tax treaties, and it is common practice to exempt non-residents' deposits from tax liabilities. However, it would be taking things to an extreme to conclude *a priori* that capital flight is welfare-enhancing; it would first be necessary to determine how tax revenue is spent and how much weight upper-income groups have in society's welfare function.

2. Liberalization of the capital account: policy evolution since the war

a) *Liberalization of capital transactions: recent trends in developed countries*

For the most part, liberalization processes have been cautious and very gradual in the developed economies of the world. A global trend towards open capital accounts started in the industrialized countries and was formalized in the 1961 OECD Codes of Liberalization. The goal of the Codes was to make a transaction between non-residents as easy as one between residents of a country. The original Codes focused mainly on medium-term capital movements, but in 1989 they were modified to include short-term capital flows. The Codes are meant to guide the liberalization process in the industrialized countries; indeed, they subject member countries to regular reviews, in which they must justify their reservations regarding implementation of any aspect of the Code as well as any temporary backsliding they may have experienced with respect to previous liberalization measures (Ley, 1989).

The Codes emerged as a collective plan for liberalization of restrictions on foreign exchange transactions so as to avoid the costs caused to member countries by unilateral actions. In the 1950s all the OECD countries had some type of major restriction, in line with the prevailing orientation of public policy at that time and the notion of national autonomy. In particular, controls helped to give more autonomy to monetary policy in the context of fixed exchange rates of the Bretton Woods system.

The countries that first began to liberalize restrictions were Canada, the United States, Switzerland and Germany, which had eliminated practically all their controls by the end of the 1950s. However, the last three countries periodically reintroduced controls in the 1960s and 1970s to deal with conjunctural problems involving exchange rates and/or the balance of payments. Indeed, controls continued to play an important role in most OECD economies during this period (OECD, 1993).

A more marked liberalization trend began in the 1980s. This pattern can be seen in table X.2, which describes the situation for a representative group of OECD countries.[43] As may be seen, a few countries like Germany, Canada, and the United States started out the decade with no restrictions on the movement of foreign exchange, while some countries radically eliminated all their restrictions at once: this is clearly seen from the table in the case of the United Kingdom, but it is also true of New Zealand and Australia (not shown in table X.2).[44] Most countries, however, took a gradual approach, with the poorer Southern European countries being the most gradual of all. At the beginning of the 1990s, France and several other OECD countries still maintained some substantial restrictions on movements of foreign capital.

It is clear, then, that most industrialized countries have generally been cautious in managing foreign exchange movements and the opening of their capital account.[45] It is also clear that the Codes of Liberalization have undoubtedly served to drastically reduce foreign exchange restrictions in the OECD area. Even so, it seems that the consensus on the need for an inflexible commitment to an open capital account has been weakened by recent speculative attacks on OECD currencies and the doubts that many have about the degree to which movements of resources are motivated by long-term

43 The table uses a homogeneous source of data: IMF information on foreign exchange restrictions on the trade and capital accounts. The data only indicate whether the restrictions exist or not, not their intensity or scope.

44 The countries which carried out such radical liberalization tended to experience some serious economic problems at least to begin with. For a good case study of New Zealand, see Chapple (1991).

45 For instance, Japan and Denmark took 16 and 15 years, respectively, to carry out this process (OECD, 1993).

Table X.2
INDUSTRIALIZED COUNTRIES: EVOLUTION OF EXCHANGE RESTRICTIONS [a]

	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991
	Germany [b]					**Canada**					**United States**				
A. Exchange rate															
1. More than one exchange rate for capital transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. More than one exchange rate for imports and exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
a. More than one rate for exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
b. More than one rate for imports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
B. Quantitative restrictions on foreign exchange payments															
1. On current account transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. On capital account transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
C. Surcharges															
1. Advance import deposits	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Requirements for surrender of export proceeds	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
	France					**Japan**					**United Kingdom**				
A. Exchange rate															
1. More than one exchange rate for capital transactions	X	-	-	-	-	-	-	-	-	-	X	X	-	-	-
2. More than one exchange rate for imports and exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
a. More than one rate for exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
b More than one rate for imports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
B. Quantitative restrictions on foreign exchange payments															
1. On current account transactions	X	-	-	-	-	-	-	-	-	-	X	-	-	-	-
2. On capital account transactions	X	X	X	X	X	X	X	X	-	-	X	X	-	-	-
C. Surcharges															
1. Advance import deposits	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. Requirements for surrender of export proceeds	X	X	X	X	X	X	-	X	-	-	X	X	-	-	-

Table X.2 (concluded)

	Spain					Greece					Italy				
	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991
A. Exchange rate															
1. More than one exchange rate for capital transactions	-	-	-	-	-	-	-	-	-	-	-	X	X	-	-
2. More than one exchange rate for imports and exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
a. More than one rate for exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
b. More than one rate for imports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
B. Quantitative restrictions on foreign exchange payments															
1. On current account transactions	X	X	-	-	-	X	X	X	X	X	-	X	X	-	-
2. On capital account transactions	X	X	X	X	X	X	X	X	X	X	X	X	X	-	X
C. Surcharges															
1. Advance import deposits	X	-	-	-	-	X	X	X	-	-	-	-	-	-	-
2. Requirements for surrender of export proceeds	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X

	Portugal					Sweden					Finland				
	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991	1970	1975	1980	1984	1991
A. Exchange rate															
1. More than one exchange rate for capital transactions	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
2. More than one exchange rate for imports and exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
a. More than one rate for exports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
b. More than one rate for imports	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-
B. Quantitative restrictions on foreign exchange payments															
1. On current account transactions	X	X	X	X	-	-	-	-	-	-	X	-	-	-	-
2. On capital account transactions	X	X	X	X	X	X	X	X	X	X	X	X	X	X	-
C. Surcharges															
1. Advance import deposits	-	-	-	-	-	-	-	-	-	-	-	X	-	-	-
2. Requirements for surrender of export proceeds	X	X	X	X	X	-	-	-	-	-	X	X	-	-	-

Source: ECLAC, on the basis of International Monetary Fund, *Exchange Arrangements and Exchange Restrictions*, Annual Report, various issues.

[a] X indicates the existence of one or more restrictions. [b] Up to 1991, data refer to Federal Republic of Germany.

considerations (fundamentals).[46] Thus, the use of temporary controls on short-term capital has recently been mooted, and indeed Spain, Portugal and Ireland reintroduced certain restrictions in the autumn of 1992 in order to deal with serious currency instability.[47] However, by the end of the year the situation had calmed down enough to allow the countries to relax the restrictions once more (OECD, 1993).

b) Recent trends in developing countries

There is a broad consensus that international capital mobility is a necessary component of the development process. Moreover, it may be recalled that external capital has many and diverse potential roles. However, most of these arguments analyse capital-as-a-whole and take no account of important real world conditions such as informational bottlenecks, the institutional peculiarities of investors, the structure of the market within which investors operate, the volume and timing of financing, its costs and volatility, public regulation and incentive structures, and the recipient country's political and economic matrices. These and other factors do not always mix in ways which permit countries to tap the full potential benefits of external capital movements. Indeed, systemic market failure can and does occur. Frequent reminders of this problem are the major financial crises, accompanied by macroeconomic collapse, that have appeared in economic history, including the recent crisis in Latin America.

Since the real world can condition the merits of even the most attractive theoretical arguments, it is not surprising that lively debates have arisen over the functioning of international financial markets, capital mobility and open capital accounts. The debate has been further fuelled by the fact that many of the most important benefits attributed to capital mobility —e.g., the use of external savings to supplement domestic saving for financing development— do not necessarily require an open capital account *per se* (Williamson, 1983), for while liberalization allows more *individuals* to interact with foreign capital markets, similar volumes of capital flows could in principle be realized through a relatively limited number of channels in the capital account.

The evolution of positions on the question of open capital accounts has been very interesting. On the one hand, the number of proponents of open capital accounts in developing countries has steadily grown over the years, to the point where many consider that an open capital account should be a major objective of economic policy. Indeed, during the 1980s developing countries were under heavy pressure to open their capital accounts. On the other hand, however, there is a growing trend towards more pragmatic thinking regarding capital account opening; this view counsels caution and gradualism, to the point of severely questioning the urgency of a perfectly open capital account, at least over a time horizon relevant to economic policy determination. More recently, there has been some sympathy for the idea of permanent monitoring of short-term capital, with controls being used for its regulation if necessary. A brief review of these trends is given below.

i) *From closed to open economies.* During the 1950s and 1960s professional thinking on development predominantly focused on real economic activity rather than questions of money and financial markets, at the same time, government investment planning and major State intervention in

46 As *The Economist* (1993b) pointed out, "The market...could not care less about these fundamentals [of EEC countries]. Once investors believe that governments are unable to defend their currencies with high interest rates, the game is up. With some US$ 1 trillion a day traded on foreign-exchange markets, no amount of intervention is likely to defeat the speculators".

47 Economists Eichengreen and Wyplosz (1993) have argued that speculative attacks can and should be discouraged. Their preferred response is temporary margin requirements, with zero interest, on short-term capital inflows.

the savings/investment processes were generally considered an acceptable, if not necessary, practice for successful development.[48] Moreover, the analysis of foreign savings flows concentrated on a very limited number of channels of capital inflow, basically government-to-government bilateral foreign aid, multilateral lending and foreign direct investment.

The above situation had its roots in concrete historical circumstances. Thus, since the Great Depression of the 1930s, the activity of private markets, and international finance in particular, had been partially in recess, with a slow revival beginning only after the Korean War. As a consequence of market failures, government economic intervention in developed and developing country markets had become routine. Most countries in developed and developing areas had comprehensive controls on capital movements. Therefore, given the restrictions on private markets, governments of developing countries were often the only borrowers able to mobilize large amounts of medium- and long-term foreign credit.

State intervention in the economies enjoyed a degree of legitimization thanks to relatively successful, albeit not always efficient, economic growth performances. This policy orientation did not have a monopoly of ideas, however: indeed it was confronted by energetic competing paradigms, particularly variants of classical *laissez faire* economics. These latter arguments focused on the gross inefficiencies and rent-seeking typical of government intervention and the need to improve resource allocation through deregulation of markets and the consequent emergence of "correct" market-based prices.[49] Moreover, these ideas enjoyed a growing international following towards the end of the 1960s, due partly to the increasing difficulties that governments were encountering in bringing their regulation in line with the realities of the recovery of domestic and international market activity in the period since the war. Highly symbolic of the new trend was the decision in 1971 to abandon the Bretton Woods agreement, which had been the cornerstone of government regulation of the international monetary system.

The new trends also contributed to a decisive change in the direction of development policy. Major studies emerged which focused on the need to reduce government intervention and to liberalize markets, with special emphasis on domestic financial markets.[50] The main argument was that financial markets are the nerve center of the savings/investment process and their performance was typically being "repressed" by government intervention, with negative consequences for growth. Such so called financial repression has many dimensions, but the existence of low or negative real interest rates is at the heart of the argument. The principal prescription of these studies was therefore domestic financial deregulation and the freeing of domestic interest rates. This was expected to raise domestic savings, stimulate more and better-quality investment, improve social equity, reduce dependence on foreign aid, and raise growth rates.[51]

It was also held that an open capital account was needed as a way to raise domestic saving, deepen domestic financial markets, reduce the costs of financial intermediation through enhanced competition, satisfy individuals' demand for risk diversification and optimize country and world

48 This was symbolized in popular development theories such as the "big push", "balanced development" and "linkages".

49 For a concise summary of the so-called neo-conservative critique, see Killick (1989).

50 The pioneering studies were by Shaw (1973) and McKinnon (1973).

51 An underlying assumption was that personal savings are very interest-sensitive. In contrast, Stiglitz (1993) argues that savings and investment can actually be enhanced with a reasonable amount of financial repression. At all events, studies in Latin America have shown that there is no strong relation between high real interest rates and national saving (Held and Szalachman, 1990a and 1990b).

resource allocation: in short, most of the benefits of capital mobility outlined above were invoked. This prescription, while mainly stressing the importance of relaxing the repression of financial activity, also led logically to the need for reforms and liberalization in other areas.

ii) *Opening up and sequencing.* While those attracted to this approach were in broad agreement on the diagnosis and general policy prescription, there were big differences of opinion regarding implementation. On the one hand, there was the position that basic reforms were part of a "seamless web" and should ideally be undertaken simultaneously in a type of "big bang" (Shaw, 1973). On the other, there were those who favoured the sequencing of reforms, with the capital account being opened up only after consolidation of the other liberalization measures, with domestic financial reform and trade liberalization being given the highest priority (McKinnon, 1973). The capital account was deemed an especially sensitive area because, if it were opened up in conjunction with other reforms, that could induce a surge of capital inflows which could bring premature exchange rate appreciation, with negative consequences for the trade liberalization and resource allocation programme. According to this view, a competitive exchange rate was crucial to trade reform; hence, maintenance of capital controls could be justified as a way to temporarily reduce pressures for exchange rate appreciation.

The different policy focuses began to have real implications for Latin America in the mid-1970s when three Southern Cone countries —Argentina, Chile and Uruguay— underwent radical economic liberalization processes, inspired partly by the financial repression hypothesis. All three countries removed price controls, freed domestic interest rates, sought to make fiscal reforms and opened up their trade and capital accounts.[52]

There was an additional incentive for encouraging capital account opening. Many analysts viewed the 1970s worldwide boom in international bank lending as an inherently benign event for development. On the supply side, private financial markets —and especially the unregulated Eurocurrency market— were considered to be highly efficient and capable of imposing "market discipline" on borrowers, in contrast to the allegedly inefficient and permissive lending of multilateral and bilateral lending agencies(Friedman, 1977). Furthermore, it was felt that portfolio and direct investment decisions were based on the long-term key variables —"fundamentals"— of the countries concerned, and were therefore inherently favourable to greater order and discipline. On the demand side, there was also a popular notion that if, moreover, the borrowers were from the private sector —in contrast to public sector agencies— the resources would be deployed efficiently (Robichek, 1981). This latter consideration was especially relevant in the Southern Cone, where the private sector was a very active borrower, especially in Chile.

As already noted, the Southern Cone experiment ended in failure as the economies collapsed because of the impact of sustained or growing price disequilibria and speculative bubbles on asset prices, low domestic savings and investment, the huge external debt accumulated by the countries, and domestic insolvencies. Some attributed the failure to unexpected external shocks; others to a flawed basic concept; and still others to poor macroeconomic management. But most of the debate has focused on the failure of international financial markets and/or flawed sequencing of the liberalization reforms.

As far as market failure is concerned, it was concluded that the so-called discipline of the private financial market had simply not materialized, for instead of facing an upward supply curve for loans, with credit rationing, as would be assumed for a market with efficient lenders, many developing countries in the 1970s apparently faced a horizontal supply

52 For a detailed analysis see Foxley (1983), Ramos (1986) and Corbo and de Melo (1987).

curve, which gave inherently perverse price signals for the savings/investment process.[53]

As for the reasons for the horizontal supply curve and market failure, some have laid stress on the existence of direct or indirect public guarantees for lenders and borrowers (McKinnon, 1984 and 1991), while others have stressed flaws in the structure of international banking markets and institutional lending practices, as well as permissiveness in national and international regulatory frameworks (Devlin, 1989). The optimism about the inherent prudence of private borrowers also proved to be excessive, to judge by the overly-leveraged firms and banks in the Southern Cone.

As far as sequencing is concerned, there is now some consensus in support of the idea that the capital account opening was premature in the Southern Cone and should have been postponed until other major reforms had been consolidated and equilibrium prices established. The lesson is that during adjustment, open capital accounts (especially in periods of elastic supply of international finance) can induce surges of capital inflows with destabilizing macroeconomic and sectoral effects. In the first place, if domestic financial markets are still shallow and uncompetitive, they will not be able to efficiently intermediate a surge in capital flows, thereby threatening the sustainability of the flows themselves.

Secondly, fiscal parameters must be consolidated and policy must be flexible, for without a solid tax base and flexible fiscal instruments, authorities must rely on monetary policy to regulate the domestic economy, and it should be remembered that unless countries are willing to abandon exchange rate management, even partial opening up of the capital account can erode the effectiveness of monetary policy (Reisen, 1993a).

Lastly, since part of the capital flows are inevitably spent on non-tradables, the relative price of the latter tends to rise, with consequent real exchange rate appreciation. This in turn is reflected in widening of the current account deficit due to the fall in the production of tradables, coupled with a rise in domestic demand for them. The real appreciation of the exchange rate can obviously distort the resource allocation and investment, seriously debilitating a country's medium-term structural objective of penetrating external markets with new exports.[54] Real appreciation also tends to bring unnecessary social costs, as domestic resources most probably will have to be switched back to production of more tradable goods, through later real depreciation of the exchange rate (Edwards, 1984; Park and Park, 1993; Jiménez, 1993). This is because the counterpart of the current account deficit is an accumulation of external liabilities, which must eventually be serviced in foreign exchange.

A considerable body of expert opinion has thus emerged which urges that capital account opening should only take place after the consolidation of other major liberalization programmes, especially in the areas of trade and domestic finance; indeed, according to McKinnon (1991, p. 117), "during liberalization, stringent controls on suddenly increased inflows (or

53 In properly functioning private credit markets, borrowers face an upward supply curve for finance; this is because the more that is borrowed, the riskier the loan is at the margin, thus resulting in appropriate price signals to borrowers. With a horizontal curve, however, the marginal price of credit does not rise; this gives incentives for external indebtedness to substitute domestic savings effort (Harberger, 1981; McKinnon, 1991). In the 1970s the situation was further complicated by the fact that the supply curve was actually slanting down, meaning that increased loan volumes were accompanied by falling prices (interest rates and commissions).

54 As noted in the first chapters of this document, the countries which have successfuly devoted themselves to export activities have typically needed a very prolonged period of balanced and stable exchange rates.

outflows) of short-term capital are warranted".

Where there has been perhaps most divergence of opinion is with respect to the speed of capital account opening once the decision is taken: some have advocated rapid and ambitious opening-up, while others counsel a gradual approach. The first-named position is favoured by those who distrust government intervention in foreign exchange and capital markets and/or fear that vested interests will paralyse liberalization programmes. The second approach stems from the belief that macroeconomic stability also requires a certain sequence in capital account opening. At a more general level, a clear distinction is drawn between inflows and outflows, and it is suggested that countries should liberalize the former before the latter, partly because the benefits that can be derived from outflows are more evident for a country that has accumulated substantial net foreign assets (Williamson, 1991 and 1993b). There could also be sequencing within the components of inflows and outflows: for instance, long-term inflows could be liberalized before short-term transactions, while in the case of outflows, priority might be given to direct export-oriented investments and trade credit.

While there is no consensus on radical versus gradual opening, the gradualist approach now seems to be gaining ground; moreover, it is more consistent with the helpful insights gained from the international discussion on the sequencing of reforms. Thus, even though developing countries may have made radical reforms, it may take many years or even decades before conditions emerge —i.e., a deep and institutionally diversified domestic financial market, a broad, consolidated tax base, a diversified, internationally competitive export sector, and a wide range of available macroeconomic policy instruments— which will allow their economies to absorb unregulated movements of external capital in ways that are consistent with sustained growth and social equity.[55]

The proponents of sequencing, however, only question the order and timing of liberalization, not the ultimate objective of an open capital account, yet it could be argued that the overriding importance of macroeconomic stability, coupled with the overwhelming size of international capital markets compared with the much smaller Latin American economies and the serious imperfections existing in such markets, makes an inflexible commitment to an open capital account undesirable. Indeed, the increasing volatility of international capital flows, and the enormous amounts of foreign exchange traded every day, which are out of all proportions to real economic activity, have already given rise to renewed discussion in the industrialized countries on the potentially destabilizing behaviour of capital markets and the possible need for the temporary use of capital controls.[56] If the industrialized countries, which have the most mature markets and the largest available battery of indirect macroeconomic policy instruments, are debating the need for more direct management of some types of flows of external capital, it would certainly be reasonable for developing countries to be doing the same.

There are a number of ways to manage capital flows. The more pressing the need for management, and the more underdeveloped fiscal and monetary policy is, the more likely it is that the use of direct controls on certain types of external capital and liquidity will be warranted, even if

55 Of course, as long as there are serious imperfections in capital markets, unrestricted capital flows will never be fully compatible with macroeconomic stability. This point will be discussed later.

56 For example, in September 1992 the United States Government called for the Group of Ten countries to study new forms of international cooperation to deal with the size and complexity of the world's money markets (Graham, 1992). Meanwhile, in September 1993 Jacques Delors, President of the Council of the European Community, discussed the possible use of capital controls to manage short-term speculative flows (*Financial Times*, 1993a).

only temporarily. Of course, controls of any type are often derided as being inefficient and always capable of being circumvented by ever more sophisticated capital market operations. But as Williamson (1991, p. 139) points out, "assertions about the ineffectiveness of capital controls are vastly exaggerated." As mentioned earlier, there are obviously costs involved in the use of these instruments. However, these must be measured against the global social benefits in terms of macroeconomic stability, investment and growth as well as against the feasibility and reliability of possible alternative ways to achieve the same goal.[57] As Zahler (1992) argues, the possible micro-economic costs of regulating capital movements may be more than offset by the benefits resulting from greater macroeconomic stability. Naturally, the net result will depend on the nature of the economic climate and the quality of the regulation policies applied.

57 Korea's recent financial liberalization and capital account opening has been very gradual and Korea frequently resorts to direct controls for management of domestic liquidity. This is because the authorities find sterilization to be too expensive and they view the direct controls as powerful instruments that give predictable results (Kang, 1993).

Chapter XI

CAPITAL INFLOWS: THEIR DOMESTIC EFFECTS AND MACROECONOMIC POLICY APPROACHES

1. Macroeconomic impact of capital flows

Chapters IX and X examined in detail the resumption of private capital flows to Latin America and the Caribbean in the 1990s, after their virtual absence throughout the 1980s. This chapter examines the issue from the standpoint of the impact of these resources on the region's economies.

Both a shortage and an abundance of external funds pose challenges to economic policy. This chapter analyses, in particular, how to increase the capacity to absorb external savings so that the latter can help strengthen productive development, generate sustainable growth of the trade balance and the balance of payments and promote macroeconomic policies which encourage investment and increased productivity. Policies adopted by different countries of the region are examined, bearing in mind the effect that the interrelationship between the financial and macroeconomic dimensions has on two of the basic pillars of changing production patterns with social equity: the generation of savings and their intermediation to strengthen regional competitiveness.

As discussed in the previous chapter, one of the main arguments —from the perspective of a developing country— for promoting a linkage with external capital is that it offers an opportunity of mobilizing external savings to strengthen national savings and investment processes. It is important that external capital should supplement —rather than replace— the domestic savings effort, since domestic saving is decisive for generating the investment required by the process of changing production patterns with social equity (ECLAC, 1990a; 1992a).

When there are large-scale capital inflows into a country's economy, it is possible to distinguish two possible effects (Griffith-Jones, Marr and Rodríguez, 1992). The first is Keynesian in nature and is reflected in greater effective demand within a context of underutilization of productive capacity. It also results in a reduction of the external constraints under which the country is operating, with a consequent recovery of the rate of growth of output. If the capital inflow is only transitory, the Keynesian effect will also be transitory. If demand is financed from external sources (external savings), it is important to note that aggregate expenditure will grow even faster than output. The danger of this situation is that, if the growth of spending has been financed by external indebtedness, reversing these flows can cause output and investment to drop. If, in addition, the terms of trade are unfavourable —as in the case of Latin America during the past decade— the adverse effects on the level and growth of national income could be even greater.

In the first phase of a process of major increases in capital inflows, there is generally a tendency towards appreciation of the real exchange rate, since the entry of capital creates revaluation pressures in the foreign exchange market. This in turn intensifies the entry of capital and the movement towards exchange rate appreciation. The major appreciations in the real exchange rate observed in the period 1976-1981 were also associated with the use of the exchange rate in several countries of the region as an instrument of stabilization.

The second effect of capital inflows, as distinct from the first, is that they influence a country's productive capacity. In this case, it is important to know what proportion of these external flows goes to investment in the recipient country, how productive this investment is, and what part of it goes —directly or indirectly— to the production of tradables. If a large proportion of the investment increases production efficiently (and is transformed into largely tradable goods and services), the prospects are better for coping with changes in external debt service conditions or in volumes of external flows.

As analysed in chapter XI and demonstrated in table XI.1 and figures XI.1 and XI.2,[58] the region's experience during the 1976-1981 boom in capital inflows shows that it failed to create the conditions for a sustainable flow of capital, in a context of macroeconomic stability and stronger savings and investment processes. On the contrary, the necessary adjustment involved an intense recessive cycle, as countries coped with changes in the conditions governing international financial and commercial markets (Ffrench-Davis and Devlin, 1993).

The overspending, of about 4 percentage points of GDP, observed during 1976-1981 was accompanied in some countries of the region, particularly Argentina, Chile and Uruguay, by large financial "bubbles" of a speculative nature.[59] The value of domestic financial and real estate assets grew at significantly higher rates than output and income, and domestic interest rates remained above the levels observed in international financial markets. The financial bubbles were attributable basically to two factors: i) large inflows of capital (stimulated by the high interest rate differential); and ii) the corresponding exchange rate lag sustained by these flows. The severe problems faced by domestic financial systems during the debt crisis show that these factors were not sustainable over time (Ramos, 1986; Corbo, de Melo and Tybour, 1985).

As already indicated, in the 1990s a number of countries of the region have re-established links with international financial markets, enabling them to reactivate their production systems. However, the circumstances prevailing in international markets for goods and services have not generated conditions conducive to a full recovery of the region's economies. The terms of trade continue to have increasingly adverse effects (see table XI.1) and the resulting loss of resources increased by nearly 50% between the periods 1983-1989 and 1990-1992. At the same time, the relative weight of external debt servicing has declined because of the fall in international interest rates, although its level remains high.

In 1990-1992, net capital inflows reached an annual average of US$ 33 billion (in 1980 dollars). About half this amount went to build up the Latin American and Caribbean countries' inadequate international reserves, and the rest to finance the current account deficit (2% of GDP). While this figure doubled the external savings of the 1980s, for the period 1990-1992 it was still lower than factor payments. This, combined with the adverse effect of the terms of trade, explains

58 Except where otherwise indicated, the figures in the text and the tables are expressed in 1980 dollars.

59 These countries were pioneers in the region in the area of deregulation and liberalization of domestic financial markets. Chapter XII analyses the various experiences of the countries of the region in supervising and regulating commercial banks.

Table XI.1

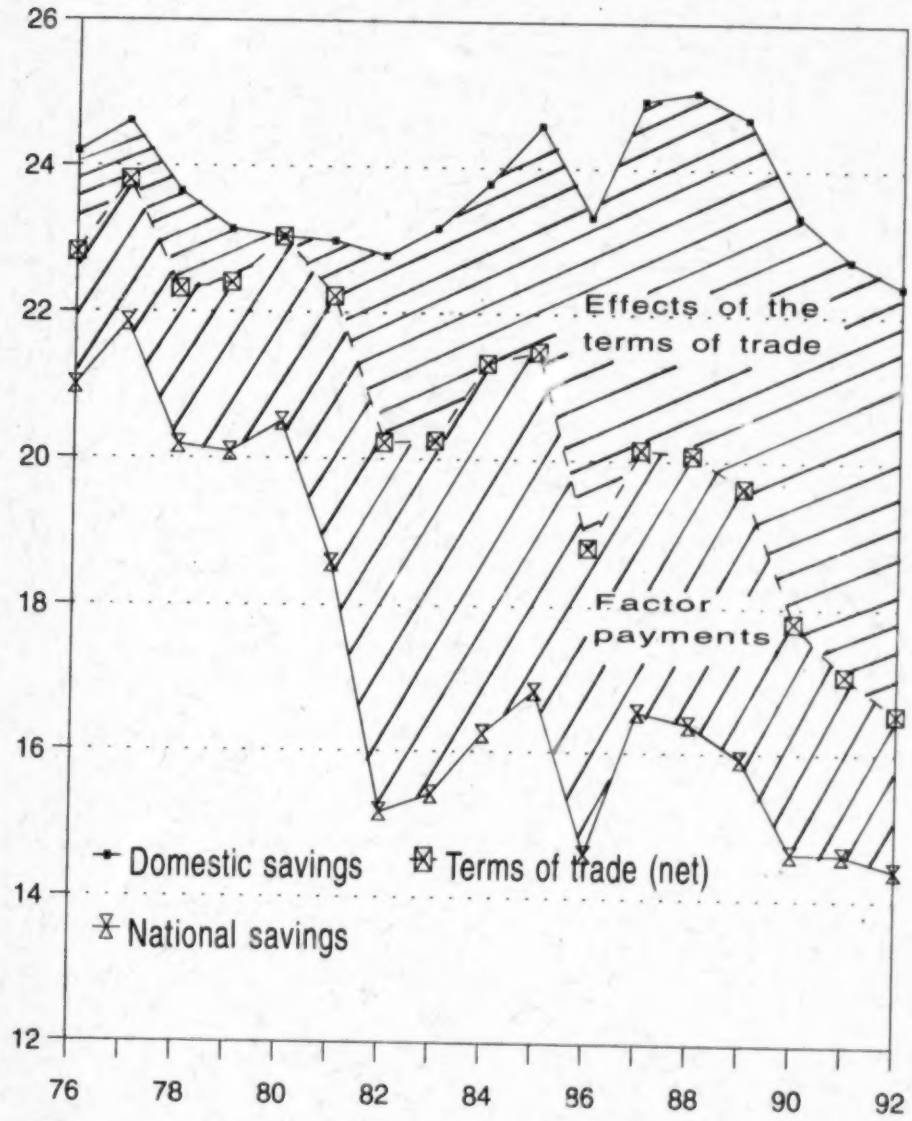
LATIN AMERICA: MACROECONOMIC INDICATORS

	Latin America (thousands of 1980 dollars)						Latin America (percentages of GDP)					
	1976-1981	1983-1989	1990-1992	1990	1991	1992	1976-1981	1983-1989	1990-1992	1990	1991	1992
1. Net inflow of capital	32 536	7 781	33 318	17 971	32 639	49 345	4.9	1.0	3.9	2.2	3.8	5.6
2. Variation in reserves	6 423	-98	16 027	11 957	16 120	20 004	1.0	-0.0	1.9	1.4	1.9	2.3
3. External savings (1 + 2)	26 113	7 879	17 291	6 014	16 519	29 341	3.9	1.0	2.0	0.8	1.9	3.3
4. Deficit on current account with minus sign (5 + 6 + 7 + 8)	26 113	7 879	17 291	6 014	16 519	29 341	3.9	1.0	2.0	0.8	1.9	3.3
5. Terms-of-trade effect [a]	5 422	31 191	48 737	45 853	48 623	51 735	0.8	4.0	5.7	5.6	5.7	5.9
6. Trade deficit	4 338	-56 017	-53 425	-65 992	-53 156	-41 128	0.6	-7.2	-6.3	-8.0	-6.2	-4.7
7. Factor service	16 905	34 561	27 137	30 306	26 525	24 580	2.5	4.5	3.2	3.7	3.1	2.8
8. Transfers [b]	-552	-1 856	-5 158	-4 153	-5 474	-5 845	-0.1	-0.2	-0.6	-0.5	-0.6	-0.7
9. GDP total	670 552	775 030	854 695	825 074	856 502	882 510	100.0	100.0	100.0	100.0	100.0	100.0
10. GNI (9 - 5 - 7 - 8)	648 777	711 134	783 979	753 068	786 828	812 040	96.7	91.8	91.7	91.3	91.8	92.0
11. Consumption	512 595	587 107	659 563	633 328	661 572	684 790	76.4	75.7	77.2	76.8	77.2	77.6
12. Investment	162 295	131 906	141 707	132 765	141 510	157 000	24.2	17.0	16.6	16.1	16.5	17.8
13. Excess of expenditure over output (9 - 11 - 12) = 6	4 338	-56 017	-53 425	-58 981	-53 420	-40 720	0.6	-7.2	-6.3	-7.1	-6.2	-4.6
14. Excess of expenditure over income (10 - 11 - 12) = 4	26 113	7 879	17 291	13 025	16 254	29 750	3.9	1.0	2.0	1.6	1.9	3.4
15. Per capita GDP	2 044	2 000	1 998	1 966	2 003	2 025						
16. Per capita GNI	1 978	1 836	1 835	1 795	1 840	1 864						
17. Rate of growth of GDP	4.44	1.80	2.36	0.30	3.80	3.00						
18. Rate of growth of goods exports	6.08	4.85	5.19	5.82	3.41	6.34						
19. Rate of growth of goods imports	6.11	5.57	15.50	11.19	15.56	19.77						
20. Goods exports	81 783	121 793	155 442	148 810	153 880	163 639	12.2	15.7	18.2	18.0	18.0	18.5
21. Goods imports	79 559	69 267	105 413	89 344	103 242	123 652	11.8	8.9	12.3	10.8	12.1	14.0

Source: ECLAC, on the basis of figures from the balance of payments and national accounts of the countries concerned.

[a] Resources necessary to cover the loss resulting from the increased price of imported goods as compared with goods exported by the region, measured at 1980 prices. [b] Corresponds to private flows in the form of donations and other non-official operations.

Figure XI.1
LATIN AMERICA: DOMESTIC SAVINGS AND NATIONAL SAVINGS
(Percentages of GDP)



Source: ECLAC, Statistics and Economic Projections Division, on the basis of official figures.

Figure XI.2
LATIN AMERICA: BALANCE OF TRADE IN GOODS AND SERVICES
(Billions of 1980 dollars)

Source: ECLAC, Statistics and Economic Projections Division, on the basis of official figures.

why domestic expenditure still remained lower than GDP. The investment rate, for its part, was even lower than the average recorded in 1983-1989.

The experience of the region in the past decade and a half provides valuable lessons about the way in which the short-term macroeconomic situation, in a context of renewed linkages with international financial markets, influences the design of economic policy. A relative abundance of capital flows leads to exchange rate appreciations which can be incompatible with medium- and long-term objectives. The authorities must base their decisions on four major objectives: i) to maintain stable capital inflows; ii) to sustain a competitive exchange rate; iii) to ensure the stability of monetary aggregates and prices; and iv) to promote savings, channelling them primarily towards investment in sectors that will increase the competitiveness of the economy.

2. Use of external capital and questions of economic policy

The return to international financial markets and the lessons of the past two decades suggest the need to design an economic policy based on three conditions: i) the impact of external funds must not have an adverse effect on the efficient allocation of resources in the economy, which should be oriented towards sustained growth driven by international competitiveness as the driving force of the economy; ii) the absorption of external savings must not be a disincentive to national savings, in order to achieve the investment required for long-term growth; and iii) measures for managing the balance of payments (exchange rate policy and regulation of short-term movements) must not needlessly discourage the entry of long-term capital (Calvo, Leiderman and Reinhart, 1993; Reisen, 1993b).

An initial level of intervention arises in the foreign exchange market. The purpose of intervention, in this case, is to moderate trends towards excessive appreciation of the real exchange rate, since this rate has become one of the main instruments of export promotion.[60] Its role has become more important as a result of the processes of trade liberalization and renewed access to the international capital market. Variations in reserves reflect official sales and purchases of foreign exchange and the extent to which the Central Bank intervenes in the foreign exchange market. This intervention is designed to lend stability and credibility to an exchange rate policy that will send out signals conducive to permanent, sustainable growth. This point was stressed recently by the President of the Central Bank of Chile (Zahler, 1992, p. 161): "From a macroeconomic standpoint, the impact of an 'excessive' inflow of [external] capital on the level of the real exchange rate may be even greater than that of increased exchange rate volatility. If the exchange rate remains below equilibrium for too long, it will have at least two kinds of undesirable effects. First, the tradables sector of the economy may be hurt. It is a well known fact that many of the economies that have been successful in recent years (especially the small ones) have based their development on the growth of the export sector ... Second, ... sooner or later the value of the currency will have to return to its level of long-term equilibrium (or even rise above it for a time), and this will put pressure on prices, thereby jeopardizing the goal of curbing inflation."

In general, countries have adopted a more conservative position as regards the proportion of capital flows channelled towards financing the current account deficit of the balance of payments. As a result, in 1992, the countries of the region devoted only 60% of these inflows to financing the deficit (use of external savings), i.e., US$ 30 billion (in 1980 dollars); the

60 This has not always been the criterion followed. As will be seen later, the exchange rate, in a context of increasing capital inflows, has in some cases served anti-inflationary purposes.

corresponding proportion in 1980-1981 was 100%, as is shown in table XI.2.[61]

At the first level of intervention, two very different situations can be observed, depending on how central banks respond to increases in capital inflows. One response is not to intervene at this first level (not to accumulate reserves). In this case, capital flows would not bring about any changes in the international assets held by central banks and their entire increase would put pressure on the exchange market to revaluate. In this way, the capital market is made to contribute to financing the net increase in imports of goods and services.

The other situation occurs when the central bank intervenes at the first level by accumulating reserves. This involves sterilizing the effects on the foreign exchange market, but has repercussions on the money market. In this situation, a decision must be taken whether or not to sterilize the effects of the accumulation of reserves —which, in fact, influences the degree of liquidity of the economy— by increasing the money supply. At this second level, intervention involves choosing between an active or a passive monetary policy (in terms of managing aggregate demand), which also determines its relationship with stabilization. In extreme cases, if the monetary authorities intervene actively and buy up all the foreign exchange brought in by capital inflows, the increase in the capital account balance will be equal to the increase in the official reserves. In this case, sterilization of these resources means that, at least in the short term, the Central Bank is preventing them from being used to finance the current account deficit, thereby avoiding their being channelled towards the domestic market in the form of the use of external savings. Moreover, there is no change in the gap between national savings and investment, or in the net external wealth of the economy. However, the Central Bank must try to sterilize the monetary effects of foreign exchange operations in order to maintain the real value of the exchange rate (Calvo, Leidermann and Reinhart, 1993).

In the final instance, countries can always consider revising the nature of the capital account liberalization in order to regulate the composition of inflows and bring them more into line with the country's development objectives. A third level of intervention then occurs. Most countries have chosen to open up to the inflow of capital and to establish only those intervention mechanisms that will prevent the entry of short-term speculative capital which does not contribute to the investment process.

To sum up, policy options are available at three levels: i) intervention in the foreign exchange market through an accumulation of reserves compatible with the various aspects of exchange rate policy; ii) Central Bank sterilization of the monetary effect of the accumulation of reserves in order to influence the level and composition of aggregate demand; iii) regulation of capital movements in order to alter their level and composition in favour of long-term flows.

Since economic authorities have reacted in different ways to capital inflows, depending on the short-term situation of their respective economies, a wide variety of policy measures has, in practice, been adopted in the region. These measures will now be considered.

a) Capital inflows and their macroeconomic effect

Capital inflows have brought to light an important policy dilemma as regards efforts to restore economies to a situation of growth. On the one hand, they have provided the financing needed to carry out, in a more socially efficient way, the structural adjustment programmes initiated by several countries in the 1980s. On the other, they have posed challenges as regards introducing safeguards de-

61 Given this amount of external savings and according to ECLAC estimates (1990a), in order for the region to grow at an annual rate of 5%, national savings would have to reach US$ 190 billion (in 1980 dollars), an increase of 50% over their present level.

Table XI.2
LATIN AMERICA: SELECTED INDICATORS
(Percentages of GDP based on 1980 dollars)

	1976-1979	1980-1981	1982	1983-1989	1990	1991	1992
Net inflows of capital	4.9	4.7	2.6	1.0	2.2	3.8	5.6
Variation in reserves	1.6	-0.1	-2.7	0.0	1.4	1.9	2.3
External savings	3.4	4.8	5.3	1.0	0.7	1.9	3.3
Effect on recovery							
Rate of variation of GDP (%)	5.3	3.1	-1.2	1.8	0.3	3.8	3.0
Goods imports	11.6	12.3	10.2	8.9	10.8	12.1	14.0
Investment	24.1	24.4	20.4	17.0	15.4	16.6	17.7
Per capita GDP in 1980 dollars	1 996	2 000	2 046	1 985	1 966	2 003	2 025
Medium-term effect							
Domestic savings	23.9	23.0	22.8	24.2	23.4	22.8	22.4
National savings	20.8	19.5	15.2	16.0	14.6	14.6	14.4
Goods exports	12.0	12.5	13.4	15.7	18.0	18.0	18.5
Non-financial external balances							
Trade balance (exports-imports of goods)	0.4	0.2	3.2	6.8	7.2	5.9	4.5
Non-financial current account (exports-imports of goods services)	-0.2	-1.4	2.3	7.2	8.0	6.2	4.7

Source: ECLAC, Statistics and Economic Projection Division, on the basis of official data.

signed to prevent them from triggering financial crises, guarantee the stability and sustainability of macroeconomic equilibria and promote investment. Concern about these challenges has re-emerged as a key element in policy design, as a result of the renewed links with international financial markets.[62]

For the region as a whole, the entry of capital has had positive effects, in that it has enabled existing productive capacity to be used more fully and production, incomes and employment to pick up as a result.[63] As can be seen from table XI.2, together with the processes of external liberalization initiated as part of adjustment programmes, the lifting of external constraint at the beginning of the 1990s has permitted: i) the recovery of regional import capacity, as reflected in the increased

62 ECLAC documents have drawn attention to two aspects related to the degree of availability of external financing: i) the need for countries, once structural adjustment processes have been initiated, to have access to external financing to facilitate each of the different stages (ECLAC, 1990a, pp. 49-59); ii) as shown by the experience of the 1970s, a decade during which a number of countries of the Southern Cone experienced bubbles and financial crises, liberalization and financial openness should take place in an appropriate macroeconomic and regulatory framework (Corbo, de Melo and Tybout, 1985; ECLAC, 1990a and chapter XII of this document).

63 The external constraint under which the region's economies were operating did not allow them to make use of their productive capacity. Once the frontier of production usable over the short term has been reached, the prospects for continued growth depend on savings and investment efforts and improvements in productivity.

share of imports in GDP by comparison with the period of external constraint; ii) the recovery of economic growth, whose annual rate increased from 1.8% between 1983 and 1989 to over 3% between 1990 and 1992 without an increase in investment. The recovery is based largely on the fact that the greater availability of external financing has made it possible to finance larger imports of inputs to increase the use of existing productive capacity, and this, through its effect on output and income, is reactivating the levels of aggregate demand. One special concern of the economic authorities is that the aggregate expenditure of the economy should be channelled not only towards consumption but also, and to a large extent, towards investment in sectors that produce competitive tradable goods. This largely depends on the price incentives offered by the economy, especially the exchange rate.

Together with recovery, the speed with which capital inflows have closed the external gap and generated a surplus of external funds has been reflected in a tendency towards exchange rate appreciation,[64] a rapid reduction in trade surpluses and an increase in the current account deficit (increase in the use of external savings). These trends reflected, initially, the recovery of "normal" levels of aggregate demand, imports and the real exchange rate, all of which were conditioned by external constraint during the period 1983-1989. The continuing abundance of capital is tending to maintain these trends over time, confronting the economic authorities with a dilemma crucial to future stability, in that, if the capital inflows are reversed, the levels of aggregate spending, imports and the exchange rate may not be sustainable in the medium and long term. In their equilibrium values, these variables should reflect the internal conditions of the goods and money markets, as well as the availability of external savings, which depends on the permanent or transitory nature of capital flows.

Table XI.2 shows that in the three years 1990-1992: i) a larger proportion of capital inflows was devoted to the accumulation of reserves than in the past, thereby moderating the impact of these resources on the region's economies; ii) the share of imports in GDP increased; iii) domestic expenditure rose more than output and income, while the surplus in the non-financial current account and the total balance of payments was reduced —equivalent to an increase in the use of external savings; and iv) national savings were displaced by external savings, as reflected in the fact that the increase in total investment was less than the increase in external savings.[65] In 1976-1981, the loss was 0.8 points of GDP and external savings were equivalent to 3.9 percentage points of GDP.

The effects of the new inflows of capital have not been the same in every country. This is also true of the access to such resources and the use which the region's economies have made of international financial markets. The capacity to absorb these flows, and the policies pursued by countries, have been affected by the point reached by each country in the process of economic adjustment (initial conditions) In fact, the renewed links with international financial markets caught

64 In recent years, the countries of the region have tended to modify their exchange rate policies, without necessarily avoiding exchange rate appreciation. Table XI.3 shows that most of the countries have an active exchange rate policy, with first-level interventions. Figure XI.3 illustrates the changes observed in the real exchange rate in 18 countries of the region, 16 of which have experienced currency appreciations since 1990.

65 Something similar occurred during the gestation of the debt crisis. However, at that time, the reduction in national savings responded to a marked expansion of consumption, while now it is the result of a decline in income brought about by deteriorations in the terms of trade. In 1990-1992, this loss of income represented 5.7% of GDP in 1980 dollars, while external savings represented 2 percentage points of GDP.

countries at different stages of their adjustment programmes.[66]

b) Policy approaches

The countries of the region have used a variety of policy instruments to tackle the conflicts described above. In general, within a context of financial liberalization, the instruments adopted have been directed primarily at the so-called first and second levels of intervention. Depending on the importance attached to the need to mitigate trends towards currency appreciation, the authorities have carried out different interventions in the exchange market; moreover, according to whether they have chosen to pursue an active or a passive monetary policy, they have introduced different degrees of intervention to regulate aggregate demand. Some countries have also regulated capital inflows in order to influence their composition and bring them more into line with their development objectives.

The possible combinations between the first and second levels of intervention yield different mixes of exchange rate policy and monetary policy which make it possible to distinguish two major intervention alternatives. The first, favoured by countries which have chosen to maintain a passive monetary policy, is that known as *non-sterilized intervention*. It involves accumulating substantial international reserves, since the Central Bank buys the foreign currency brought in by capital flows in exchange for national currency, without sterilizing the monetary effect of these operations, under a controlled exchange rate system.[67] This avoids an appreciation of the nominal exchange rate; however, if adjustment by way of an increase in imports does not occur fast enough, this alternative can expand the monetary base beyond desirable limits. This usually results in inflationary pressures, causing appreciations in the real exchange rate and tendencies towards excesses and changes in the composition of expenditure.

The second alternative, adopted by countries which, together with defending the exchange rate, have chosen to pursue active monetary policies, is known as *sterilized intervention*. Like non-sterilized intervention, it involves accumulating reserves, but systematically approaches the second level of intervention by applying a sterilization of the monetary effects of these operations. The purpose is to isolate the money stock from fluctuations stemming from the mobility of foreign capital. This type of sterilization, if effective, prevents domestic real interest rates from falling. In economies that are making full use of their productive capacity, this has the advantage of helping control aggregate spending and preventing further appreciation of the real exchange rate. However, with this option, if interest rate differentials persist, capital inflows continued to be stimulated, generating further needs for sterilization; at the same time, the intervention may be a source of quasi-fiscal deficits, since the Central Bank is placing commercial paper in the domestic market at higher interest rates than those it obtains on its international reserves.

The sterilized intervention alternative is not problem-free. Conflicts arise mainly when there is too little flexibility in the tax system for national economic authorities

66 Some countries found themselves confronted with the need to initiate or strengthen *macroeconomic stability*; others, already more advanced in the stabilization of their economies but with idle productive capacity, were at a stage oriented to encouraging *reactivation of the productive apparatus*; lastly, others (with inflation under control and signs of reactivation of their productive apparatus) were strengthening their *savings and investment capacity*, so as to attract the financial resources that would enable them to expand their productive capacity and achieve *sustainable economic growth*. While the description of these stages is illustrative of the components of an adjustment programme, they do not necessarily follow the order implicit in this presentation.

67 The usual forms range from fixing the nominal exchange rate and mobile parity to dirty floating within pre-established bands.

Table XI.3
LATIN AMERICA AND THE CARIBBEAN: EXCHANGE RATE SYSTEMS OPERATING IN MID-1993

Fixed dollar	Floating band	Floating with intervention [f]	
1. Argentina	1. Chile [b]	1. Bolivia	7. Haiti
2. Panama	2. Colombia [c]	2. Brazil	8. Honduras
	3. Mexico [d]	3. Costa Rica	9. Jamaica
	4. Uruguay [e]	4. El Salvador	10. Paraguay
Mini-devaluation		5. Ecuador	11. Peru
1. Nicaragua [a]		6. Guatemala	12. Trinidad and Tobago
			13. Venezuela

Source: ECLAC, Economic Development Division, on the basis of information from the countries concerned.
[a] System of daily mini-devaluations since 1992. [b] Dirty float within a band which fluctuates around a benchmark exchange rate, determined in accordance with a basket of currencies of the main trading partners. [c] Benchmark exchange rate determined by the resale value of an exchange certificate. [d] Without intervention but with a fixed nominal floor and a ceiling which slides at the rate of 0.40 thousands of a new peso per day. [e] The minimum of the band is fixed daily, correcting the dollar quotation on the basis of the annual monetary programme. The width of the band is 7% above the minimum. [f] Floating exchange rate regimes, with Central Bank intervention. Of these, the Central Banks of Bolivia, El Salvador and Guatemala apply auction mechanisms (daily or weekly). In Honduras (for official transactions) and the Dominican Republic, the monetary authorities adopt a benchmark quotation which follows trends on the free market. In Brazil, Costa Rica, Ecuador, Paraguay, Peru, Honduras (for private transactions) and Venezuela, foreign currency quotations are determined in the foreign currency market, usually that of the banks.

to be able to use this policy to offset domestic or external shocks.[68] What happens in these cases is that the executive branch is deprived of yet another policy instrument and hence cannot use fiscal tools when it wants to moderate aggregate spending or stimulate the economy, but must rely solely on monetary and exchange rate instruments. A more flexible tax system permits a better policy mix and more stable interest and exchange rates.

In the absence of a flexible fiscal policy, the problems of sterilized intervention arise from the dilemma confronting the economic authorities when they try to control, simultaneously, the real interest rate (as an instrument of monetary policy for implementing stabilization policies) and the real exchange rate (as an instrument of trade policy for promoting the growth of tradable-producing activities). If an interest rate consistent with the objective of curbing inflation (by sterilizing the monetary effects of accumulating reserves) is higher than the international rate adjusted for expectations of devaluation, the entry of capital will continue to exert pressure towards appreciation of the real exchange rate, thereby jeopardizing the objective of protecting the tradables sector of the economy. Conversely, if the domestic interest rate is allowed to fall, both objectives are thwarted, since the higher expenditure induced by lower interest rates will put pressure on prices and will also lead to an

68 What happens today is that, in most of the region's (and the world's) democracies, legislative approval is required for changes in the tax system. This means that large majorities must be put together in order for tax reforms to be agreed, and this limits the flexibility of the economic authorities.

overvaluation of the real exchange rate (Zahler, 1992).

It is for this reason that, in practice, the alternative of sterilized intervention has been combined with other policy measures, in order to take action: i) at the first level of intervention, to influence the exchange market; ii) at the second level of intervention, to regulate aggregate demand through mechanisms other than the interest rate; and iii) at the third level of intervention, to modify the level and composition of capital flows, either directly, through restrictions and charges aimed particularly at short-term capital, or indirectly, by generating exchange rate uncertainty. Among the possible measures, the following are noteworthy:[69]

At the first level of intervention, designed to influence the effects on the foreign exchange market: i) increase the demand for foreign exchange through incentives for the outflow of capital during periods of surplus funds; this can be done by relaxing the rules governing investment by nationals abroad and the repatriation of foreign direct investment, and by authorizing institutional investors to invest abroad and various debtors to make advance payments abroad; ii) apply foreign trade measures, in order to match the volume of imports, the current account deficit and the accumulation of reserves to the exchange rate appreciation targets set in the country; iii) promote the introduction of mechanisms which encourage productivity increases in keeping with the level of exchange rate appreciation.

At the second level of intervention, the purpose of which is to control the impact on aggregate demand: i) introduce mechanisms for regulating financial systems in order to avoid distortions in the sector and remedy weaknesses in the prudential financial regulation of the banking system; ii) impose fiscal discipline in order to reduce the additional pressures on demand; iii) supplement exchange rate policy with social contracts on prices and wages.

At the third level of intervention, designed to alter the composition of capital inflows: i) apply indirect exchange rate measures aimed at reducing the entry of short-term capital by introducing an element of uncertainty as to the evolution of the exchange rate, through intervention by the respective Central Bank in the determination of this rate over the short term; ii) adopt direct measures imposing restrictions on capital inflows, which can take the form of adjustments of the reserve requirements, often without interest, on bank deposits or other credits from abroad, and various kinds of quantitative controls (and requirements as to minimum maturity periods, minimum volumes for bond issues, caps on interest rates on foreign capital and regulations on the participation of foreign capital in the stock market).

i) *Experiences of non-sterilized intervention.* This alternative has often been adopted by countries which favour price stability as an objective of economic policy. It is a strategy which acts directly on inflation and indirectly on the real exchange rate. In establishing this mechanism, the expectation is that national interest and inflation rates will rapidly converge with international rates. Much of the success of this strategy ultimately depends on the confidence of economic agents in the monetary authority's ability to maintain the nominal exchange rate. This situation, in the final analysis, requires the Central Bank to maintain a large stock of international reserves, which affects the composition of its assets and liabilities.

The success of this strategy also depends on the relationship between the nominal exchange rate and inflation. If there are substantial lags[70] in the inflation-

69 Table XI.4 gives examples of these measures applied in Argentina, Colombia, Costa Rica, Chile and Mexico.

70 This refers to the element of inertia which tends to impede reduction of the inflation rate. This element is a function of the degree of formal and informal indexation of the economy and must be considered in designing an exchange rate policy for the purposes of stabilization.

ary dynamic, using the nominal exchange rate as an anchor to stabilize prices can cause marked exchange rate appreciations, with corresponding effects on other relative prices, the allocation of resources and macroeconomic equilibria. Ultimately, if this trend persists and domestic inflation systematically exceeds external inflation, the authorities must be prepared to make adjustments in the level and composition of economic activity if the real exchange rate deviates very significantly from its long-term value.

While, in practice, countries can be seen to have used different policy mixes, Argentina is one of the countries that have come closest to this alternative, starting from high levels of inflation.

In recent years, Argentina has adopted a series of measures designed, in general, to deregulate the various markets, including those related to capital movements. With regard to the operation of the foreign exchange market, the Convertibility Act promulgated in March 1991 (which fixed the nominal exchange rate with a parity of one to one with the dollar and also established the legal validity of contracts denominated in different currencies) permitted extensive deregulation of the operations of this market. The explicit aim of this Act was to curb inflation and ensure the stability of the nominal exchange rate (Argentina, Ministry of Economic Affairs and Public Works and Services, 1993; Fanelli and Machinea, 1993).

Together with reforms relating to exchange rate parity, reforms were made in the monetary and fiscal spheres.[71] In September 1992, the constitution of the Central Bank was amended. Some of the main amendments were: establishment of the independence of the Central Bank, prohibition of monetary financing of the public deficit and elimination of the State guarantee of deposits. The purpose of these changes was to increase the credibility of the permanence of monetary stability over time and of the convertibility of the currency (Fanelli and Machinea, 1993; Argentina, Ministry of Economic Affairs and Public Works and Services, 1993). At the same time, policies of deregulation and opening up of the capital account were used to intensify the process of liberalization and commercial openness. This deregulation, in the context of a fixed exchange rate, helped to control the prices of internationally traded goods, thereby supporting efforts to curb inflation.

The increase in international reserves,[72] in the absence of mechanisms for sterilizing the effects of exchange rate operations, brought about a major increase in the degree of monetization of the economy (from the low levels observed after the hyperinflation of 1989); this situation, combined with the increased use of external savings and the expansion of domestic credit, increased aggregate demand and economic activity significantly during 1991-1993.

In terms of combating inflation, the policies instituted in the 1990s have drastically reduced the inflation rate. Measured according to the Consumer Price Index (CPI), this rate was 1,344% in 1990 and 8% between November 1992 and November 1993. The reduction in the inflation rate was accompanied by a marked appreciation of the real exchange rate (after a sharp devaluation in 1990, which caused a large surplus in the trade balance), a process which slowed down as the domestic inflation rate drew closer to the

71 Other measures adopted to stimulate capital movements were the Economic Emergency Act (August 1989) establishing equal treatment for foreign and national capital invested in productive sectors; the Tax Amnesty Act (April 1992); deregulation of the financial and securities markets; and, lastly, public sector reforms, which have had a major effect on capital movements, particularly the State Reform Act which paved the way for the privatization of public enterprises and established debt for equity schemes.

72 Measured in import months, reserves reached the equivalent of 15, 11 and 9 months in 1990, 1991 and 1992, respectively. In 1989, they were equivalent to 4.5 months of imports.

international rate. At the same time, the authorities promoted incentives for increasing productivity.

According to ECLAC figures, expressed in 1980 dollars, the real growth rates of GDP in Argentina were high between 1991 and 1993 (8.9%, 8.6% and 6.0%, respectively) and were accompanied by an increase in the current account deficit, which rose from 1.7 percentage points of GDP in 1991 to 4.8 points in 1992. Domestic and national savings showed a downward trend —more pronounced in the case of domestic savings, which fell from 26.6 points of GDP in 1990 to 22.1 points in 1992. Investment recovered, reaching 18.5% of GDP in 1992, although this figure was still lower than the average recorded in 1976-1979. The positive trade balance (measured in constant 1980 dollars) was reduced from 13 points of GDP in 1990 to 4 points in 1992, reflecting the greater dynamism of imports as a result of economic recovery, exchange rate appreciation and trade liberalization. In nominal terms, the merchandise trade balance changed signs: from a surplus of US$ 8,628 million in 1990 to a deficit of US$ 1,735 million in 1993, while the current account balance went from a surplus of US$ 1,903 million to a deficit of US$ 8.2 billion between the same years (ECLAC, 1993f).

To sum up, the Argentine alternative, based on the fixing of the nominal exchange rate, the adoption of monetary rules which do not sterilize the effects of capital flows on the money supply and the implementation of a set of structural reforms, has resulted in important achievements in the area of stabilization, accompanied by an appreciation of the real exchange rate which has influenced the composition of demand and the allocation of investment resources.

ii) *Experiences of sterilized intervention.* This alternative has been preferred by countries which have maintained an active monetary policy and, at the same time, a more cautious position as regards the nature of capital flows. It reflects a concern for the continued development of the tradables sector, the generation of national income and the channelling of that income towards savings and investment in that sector.

Among the countries which have opted for active intervention, Chile has done so most persistently, but others, such as Colombia, Costa Rica and Mexico, also deserve mention. Since this alternative differs from the previous one, some of the instruments used by those countries at the three levels of intervention are reviewed below (see table XI.4).

The case of Chile. Since before the debt crisis, Chile has been taking action in areas related to capital movements.[73] In 1990, the authorities had to take measures to regulate capital inflows and sterilize the monetary effects of the accumulation of reserves, through interventions in the foreign exchange and money markets. Chile used basically three instruments for these purposes: an exchange rate policy based on "dirty" floating of the exchange rate around a benchmark value determined on the basis of a basket of currencies; sterilization of the monetary effects of the accumulation of reserves through open market operations; and the application of charges and reserve requirements in order to regulate the entry of capital and discourage excessive, mainly short-term flows.

The Chilean authorities opted for intervention in order to influence determination of the real exchange rate in the short term, on the basis of two assumptions:

73 Decree-Law 600 of 1974 on foreign investment eliminated legal discrimination against foreign investors; chapters XVIII and XIX authorized external debt for equity swaps for both Chileans and foreigners; in 1989, Chile authorized the issue of portfolio securities to various enterprises for sale on foreign securities markets (*Fondos de Inversión chilenos*); in 1990, American Depositary Receipts (ADRs) were approved as an alternative to the direct issue of shares and debt instruments by Chilean enterprises in the United States (Ffrench-Davis, Agosin and Uthoff, 1993).

Table XI 4

LATIN AMERICA AND CENTRAL AMERICA: SUMMARY OF INTERVENTION MEASURES ADOPTED WITH REGARD TO CAPITAL INFLOWS, SELECTED COUNTRIES

	Argentina	Colombia	Costa Rica	Chile	Mexico
First level (Moderation of the impact of capital inflows on exchange rate appreciation - accumulation of reserves).	March 1991, Convertibility Act, designed to fix the nominal exchange rate and deregulate the foreign exchange market. Liberalization and trade opening.	June 1991: Introduction of float band *(certicambios)*. January 1992: all exporters allowed to keep part of their returns abroad, and residents allowed to keep up to US$500,000 in assets abroad without prior permission. February 1992: reduction of the minimum maturity period for exernal loans to finance working capital and fixed investment. Liberalization of trade.	Early 1992, introduction of floating with intervention.	1991: float band introduced. March 1992: "dirty" float allowed within the band. July 1992: exchange rate pegged to a basket of currencies of trading partners. 1991: increase in the percentage of foreign currency deposits which banks can use for foreign trade. Investment by nationals and pension funds abroad made more flexible. Reduction of the time-limit for remitting capital brought in through debt conversion operations.	Floating band with fixed floor. November 1991: band ceiling devalued by 20 centavos a day. October 1992: daily devaluation extended to 40 centavos of new pesos.
Second level (Sterilization of the monetary effect of exchange operations).	Strengthening of public finances and introduction of a passive monetary policy.	Strengthening of public finances. January-October 1991: active monetary policy. October 1991: interest rates freed and sterilization abandoned.	Strengthening of public finances. Monetary policy uses open market operations and reserve requirements on deposits in foreign and national currency.	Strengthening of public finances. Active monetary policy through open market operations.	Strengthening of public finances. Moderate sterilization.

Table XI-4 (concluded)

	Argentina	Colombia	Costa Rica	Chile	Mexico
Third level (Moderation of capital inflows)		June 1991: 3% tax on transactions in foreign currency generated by personal services abroad. February 1992: increase in the commission on purchases of foreign currency by the Central Bank from 1.5% to 5%. June 1992: regulation of the entry of foreign currency as payment for services.		June 1991: reserve requirement of 20% without interest must be paid on credits obtained abroad. July 1991: this requirement is extended to all credits with terms of under six months. January 1992: requirement extended to all deposits in foreign currency in commercial banks. Marginal requirements with respect to interbank deposits. Reserve requirement increased from 20% to 30%.	The amount of liabilities in foreign currency is limited to the equivalent of 10% of total liabilities.

Source: ECLAC, on the basis of various authors quoted in the text.

i) the monetary authority has a better idea of future trends in the balance of payments and their effects on the economy; and ii) its planning is longer-term than that of agents operating in short-term markets (Zahler, 1992).

Chile's exchange rate policy has undergone important changes in recent years. In 1983, it adopted a crawling peg policy, which involved determining a benchmark price for the dollar. This was devalued daily by the Central Bank on the basis of domestic and external inflation differentials. At the same time, in order to allow the market to play a role, the price for the purchase and sale of foreign exchange was allowed to float within a band around the benchmark value of the dollar. In mid-1989, this band was fixed at 5% of this value.

Since capital inflows intensified as of 1990, the official exchange rate repeatedly settled around the lower limit of the band, forcing the Central Bank to intervene. As a result, the Central Bank had to buy up US$ 1.5 billion in 1990 and US$ 3 billion in 1991 and also had to carry out numerous open market operations to sterilize the monetary effect of foreign exchange operations. As will be seen later, these measures were supplemented by reserve requirements on external credits and taxes which mainly affected short-term operations, and by the gradual liberalization of capital outflows, although this did not have the desired positive effect.

Apart from this large inflow of capital, in Chile there was an improvement in the non-financial services account, based on the vigorous development of exports of services and non-traditional goods and on reductions in the external debt service. The authorities viewed some of the factors that were contributing to the positive evolution of the current and capital accounts as being more permanent, and proceeded to accommodate these tendencies through two additional measures: i) a 2% revaluation, in June 1991, supplemented by a reduction in customs tariffs from 15% to 11%; ii) a further revaluation, of 5%, in January 1992. However, the foreign exchange market exerted persistent pressure towards a significantly higher appreciation. Convinced that they were dealing largely with transitory factors, the Chilean monetary authorities adopted a series of measures that allowed them to moderate the revaluation pressures.

Some of the main measures were: i) in 1991, they established a reserve requirement of 20% and a tax of 1.2% on short-term external credits; ii) in 1992, they widened the float band from 5% to 10% of the dollar benchmark value, in order to create more uncertainty in the formation of short-term expectations; iii) this measure was supplemented in March 1992 when the Central Bank decided to intervene on a discretionary basis within the limits of the band ("dirty" float); iv) in May 1992, the reserve requirement was raised to 30%; and v) in July 1992, exchange rate regulations were amended in order to reduce the linkage of Chile's monetary policy with that of the United States and to link it more closely with that of Chile's other main trading partners. To do this, the benchmark exchange rate was pegged to a basket of currencies, made up of the United States dollar (50%), the German mark (30%) and the Japanese yen (20%), weightings which reflect the importance of the different currency areas in Chile's foreign trade.

To sum up, in order to discourage inflows of short-term capital, prompted especially by differences between the domestic and international interest rates, the Chilean authorities have looked for ways of raising the cost of incurring debt in foreign currency abroad, through reserve requirements (and taxes), in order to equalize it with the domestic cost, adjusted by the exchange rate risk assumed by agents wishing to operate in Chile. Furthermore, by "dirty" floating and pegging of the exchange rate to a basket of currencies, the authorities have increased the

uncertainty and also the costs of short-term capital speculators.[74] These measures discourage capital inflows, thereby reducing pressures towards exchange rate appreciation and helping to regain control of the domestic interest rate and, through it, of aggregate demand and inflation.

Another important characteristic of the Chilean experience has been the Central Bank's access to the domestic financial market in order to counter the liquidity created by the accumulation of reserves, which tripled between 1989 and 1993.[75] The national financial market has developed substantially, *inter alia*, because of the reform of the pension system (see chapter XII). In fact, the pension funds' rate of accumulation of resources has been greater than the increase in the supply of authorized financial assets and they now have a majority share in the market for some specific instruments. This development of the capital market has allowed the Central Bank to place very large volumes of notes, mainly with the object of sterilizing the increased liquidity resulting from purchases of foreign exchange.

In terms of combating inflation, the policies implemented show that, if a country favours the alternative of moderating the trend towards exchange rate appreciation, it may be necessary to set inflation goals that are less stringent in the short term but not necessarily any less satisfactory by Latin American standards or compared with Chile's historical averages. The annual rate of inflation measured by the CPI dropped from over 30% at the beginning of 1990 to 13% in 1992 and 12% in 1993. This inertia in the inflation rate in recent years is a result, moreover, of the fact that the anti-inflation effort is being made in the context of a heavily indexed economy.[76]

The case of Mexico. Mexico's linkages with international financial markets began to be re-established in the second half of 1989 and have led to substantial surpluses in the capital account of the balance of payments. This has enabled the country to cope with growing deficits in current account and, at the same time, to accumulate international reserves.

Since 1983, Mexico's economic strategy has been based on two lines of action: i) macroeconomic adjustment and stabilization of price levels; and ii) structural reforms.[77] In this context, and given the possibility that new capital inflows, by expanding aggregate demand, might prevent the inflation goals set by the economic authority from being met, a number of measures aimed at reducing the impact of such flows on the economy have been adopted: i) sterilization of the effect of

74 Chile has also adopted a number of important measures to encourage selective, gradual capital outflows. In 1991, it increased the percentage of deposits in foreign currency that commercial banks could use for financing external trade; it made the process of investment abroad by national enterprises more flexible; it reduced the period for remitting capital brought in through debt conversion operations; and it authorized pension funds (AFPs) to invest part of their portfolio abroad, in low-risk instruments. In general, the effects have been limited, because investment has continued to be more profitable in Chile. The only significant developments have been investments abroad through the purchase of firms in the framework of privatization processes, and the purchase of shares in booming stock markets.

75 In 1993, these reserves reached the equivalent of one year of imports.

76 Other issues, such as the policy governing international reserves, the growth of GDP by an average of 6% in the 1990s, with a record level of investment in 1993, and the quasi-fiscal cost of the policy of sterilizing the increase in reserves (in that the interest rates which the Central Bank must pay on its notes are much higher than those it obtains on its placements in foreign currency), are examined in Ffrench-Davis, Agosin and Uthoff (1993).

77 The structural reforms were based, *inter alia*, on: i) trade liberalization; ii) modifications in the regulatory framework for foreign investment; iii) privatization of public enterprises; iv) internal deregulation (commercial, industrial, financial); v) strengthening of public finances.

foreign exchange operations; ii) relaxation of exchange rate policy; and iii) imposition of limits on the levels of external indebtedness of commercial banks (Banco de México, 1993; Gurría, 1993).

The primary objective of monetary policy has been to combat inflation, using exchange rate policy to help achieve it (Banco de México, 1993; Guzmán, 1993).

At the moment, Mexico's exchange rate policy allows the exchange rate to fluctuate within a band whose maximum point of intervention depreciates daily by a preannounced amount, while the lower level of the band remains constant.[78]

For purposes of monetary policy, this exchange rate system (controlled evolution of the nominal exchange rate) involves an endogenous money supply determined by variations in domestic credit and by the balance of payments. Thus, the main instrument of monetary policy available to the authorities is to control domestic credit, allowing the interest rate to adjust freely to the target exchange rate (Banco de México, 1993).

Open market operations to sterilize the impact of capital flows have been used with caution. It is estimated that the cost of sterilization amounted to 0.25 percentage points of GDP during 1990-1992 (Gurría, 1993).

Together with sterilization and the relaxation of exchange rate policy, in 1992 Mexico placed a limit on the amount of liabilities in foreign currency which commercial banks could hold: this amount is now equivalent to 20% of their total liabilities. The coefficient of liquidity was, in turn, maintained at 15%. This coefficient must be placed in low-risk instruments.

With regard to the objectives of stabilization, the results have been positive. The annual rate of inflation (measured by the CPI) declined from 30% in 1990 to less than 10% in the 12-month period up to November 1993 (see table XI.5). The exchange rate has shown a persistent trend towards real appreciation and in the third quarter of 1993 reached levels similar to those of 1980 (see figure XI.4). In 1980 dollars, the current account deficit rose from 3.4% of GDP in 1990 to 8.5% in 1992; total investment increased from almost 19.5% of GDP in 1991 to 20.7% in 1992 (in 1980 new pesos). Domestic and national savings have been declining —the former slipped from 24% of GDP in 1990 to 20% in 1992. The rate of growth of output recovered moderately in some years. Real growth rates were 4.4%, 3.6%, 2.6% and 1% in 1990, 1991, 1992 and 1993, respectively.[79]

The case of Colombia. During the period 1990-1992, the Bank of the Republic of Colombia accumulated international reserve stocks until it practically doubled the original balance.[80] There is now a degree of consensus among analysts that the bulk of the accumulation of reserves was a result of capital movements and not, as on previous occasions, of movements linked to exports (Carrasquilla, 1993).

During the first three quarters of 1991, capital inflows were accompanied by an active policy of sterilizing the monetary effects of reserve accumulation through open market operations and by a change in exchange rate policy, in June of that

78 In November 1991, together with abolishing exchange controls, Mexico widened the exchange rate band, allowing a devaluation of its ceiling by 20 centavos a day. In October 1992, it increased the devaluation of the ceiling to 0.40 thousandths of a new peso per day (equivalent to a devaluation of 4.5% a year). By mid-May 1993, the exchange rate was fluctuating within a band of close to 6% and it was hoped that by the end of 1993 the difference between the minimum and maximum levels would reach 9% (Banco de México, 1993). The purpose of this measure was to allow a greater margin of flexibility, so that the exchange rate could adapt to the increased supply of capital, and to widen the band in order to increase exchange rate risk, in an attempt to deter short-term capital inflows.

79 In nominal terms, the current account deficit rose from 2.9 percentage points of GDP in 1990 to 4.8 points in 1991 and 6.9 in 1992. Exports of goods and services reached, on average, around 19 percentage points of GDP in 1990-1992.

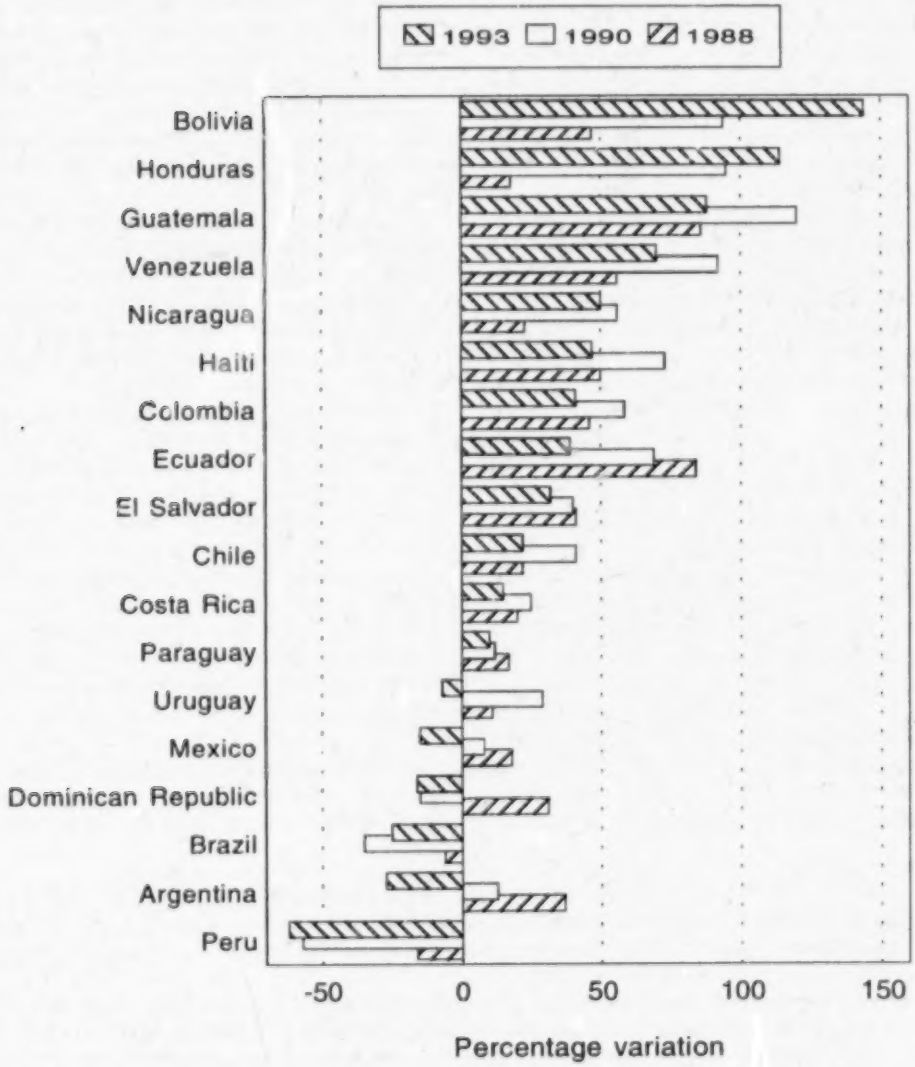
80 In 1990, reserves were equivalent to 10 months of imports; in 1992, they approached 15 months.

Table XI.5
LATIN AMERICA: INDICATORS OF RESERVES AND PRICES, SELECTED COUNTRIES

	1989	1990	1991	1992	1993
Argentina					
Reserves as month of imports	4.5	14.8	10.7	9.0	-
Real exchange rate (1985=100)	144.3	99.0	85.4	79.9	73.8
Interest rate differential					
Short term	26.4	127.7	-12.6	9.2	6.9
Long term	27.2	127.5	-14.4	6.1	4.2
Inflation according to CPI	4 923	1 344	84.0	17.0	7.7
Chile					
Reserves as month of imports	6.7	10.3	11.5	11.9	-
Real exchange rate (1985=100)	133.5	139.5	137.6	131.8	132.0
Interest rate differential					
Short term	-3.3	15.7	4.1	-12.5	10.9
Long term	-2.5	15.5	2.3	9.5	8.2
Inflation according to CPI	21.4	27.3	18.7	12.7	12.2
Colombia					
Reserves as month of imports	9.5	9.9	15.9	15.2	-
Real exchange rate (1985=100)	152.7	172.5	173.0	154.8	148.3
Interest rate differential					
Short term	-9.3	-8.4	3.7	5.5	8.2
Long term	-8.5	-8.6	1.9	2.4	5.6
Inflation according to CPI	26.1	32.4	26.8	25.1	21.2
Costa Rica					
Reserves as month of imports	5.7	3.5	6.6	5.5	-
Real exchange rate (1985=100)	110.1	112.0	120.5	115.5	110.0
Interest rate differential					
Short term	-0.1	-8.8	-8.8	11.2	4.8
Long term	0.7	-9.0	-10.6	8.1	2.1
Inflation according to CPI	10.0	27.3	25.3	17.0	9.2
Mexico					
Reserves as month of imports	3.2	3.8	5.6	4.7	-
Real exchange rate (1985=100)	110.4	107.4	98.0	90.7	85.4
Interest rate differential					
Short term	9.0	8.9	6.1	10.2	11.0
Long term	9.7	8.7	4.3	7.1	8.3
Inflation according to CPI	19.7	29.9	18.8	11.9	8.7

Source: ECLAC, Economic Development Division, on the basis of official figures provided by the countries and the International Monetary Fund; ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean 1993* (LC/G.1794), Santiago, Chile, December 1993.

Figure XI.3
LATIN AMERICA AND THE CARIBBEAN: INDEXES OF THE REAL EFFECTIVE EXCHANGE RATE [a]
(Percentage variations in relation to 1985)



Source: ECLAC, *Preliminary Overview of the Economy of Latin America and the Caribbean 1993* (LC/G.1794), Santiago, Chile, December 1993.
[a] For all countries, the consumer price index was used.

year, designed to support sterilization efforts.[81]

By virtue of this change, the Central Bank no longer pays cash for the foreign exchange it buys; instead, it pays with exchange certificates *(certicambios)*, non-interest-bearing bonds denominated in dollars with a maturity period of, at present, one year. The price for redeeming these bonds in pesos (called the official exchange rate) is fixed daily by the Central Bank.[82] At the time of their issue, *certicambios* may be sold on the secondary market at a discount that fluctuates in a band ranging from 5.5% to 12.5%. The price of these certificates in the secondary market is equivalent to the price of the dollar, known as the representative rate.

This rate fluctuates within a band whose limits are those within which the monetary authorities allow the discount on exchange certificates to fluctuate. If the ceiling of the band tends to exceed the 12.5% discount, the authorities intervene by buying *certicambios*, so that increased demand for these certificates reduces their discount (Cárdenas, 1993).

Although the exchange rate strategy makes it possible to lessen over time the monetary effects of reserve accumulation, the monetary sterilization carried out in this period was intense, and it is estimated that in 1991, its impact on the quasi-fiscal deficit reached values of between 0.5% and 1% of GDP (Cárdenas, 1993; IMF, 1993a).

In October 1991, efforts began to be made to reduce interest rates in the domestic financial system. Colombia therefore abandoned the policy of active sterilization pursued during the first nine months of 1991, and the emphasis of monetary policy progressively shifted towards gradual elimination of the differential between the domestic and external interest rates, in order to discourage inflows of speculative capital, even at the cost of allowing greater increase in means of payment than those observed in the previous period. Despite this increase, the inflation rate declined in 1992 and 1993 (Carrasquilla, 1993; Garay, 1993).

To support the application of a non-sterilized monetary policy, the tax reform approved in June 1992 introduced a measure for regulating inflows of foreign exchange related to services, as a means of influencing capital inflows, while relaxing the rules on capital outflows.[83]

The rate of inflation, measured by the CPI, was reduced from 32% in 1990 to 21% for the 12-month period up to November 1993. In 1980 dollars, the current account balance was in surplus, reaching 4.6% of GDP in 1991 but falling to 1.7% in 1992. Appreciation of the real exchange rate began to pick up speed in 1992 (see figure XI.4). The domestic savings rate, like the investment rate, stayed fairly constant in 1990-1992. The growth rate of the economy was moderate, with an average of 3.5% for 1990-1993.

Historically, the countries of **Central America and the Caribbean** have shown a different dynamic from that of the other

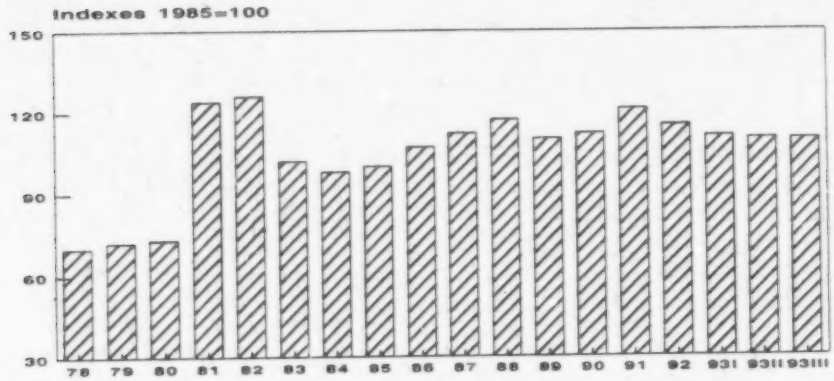
81 Other measures to reduce capital inflows included the application, in June 1991, of a 3% tax on transactions in foreign currency generated by personal services provided abroad and on other types of transfers. In February 1992, the Bank of the Republic increased the commission on foreign exchange purchases from 1.5% to 5% (IMF, 1993a).

82 This price is not an exchange rate in the strict sense, since it is not applied to a purchase or sale of foreign exchange. Rather, it reflects the price paid for a paper when it matures. In other words, the official exchange rate corresponds to the redemption price, in pesos, paid by the Bank of the Republic at the time of repurchase of the *certicambio* (Cárdenas, 1993).

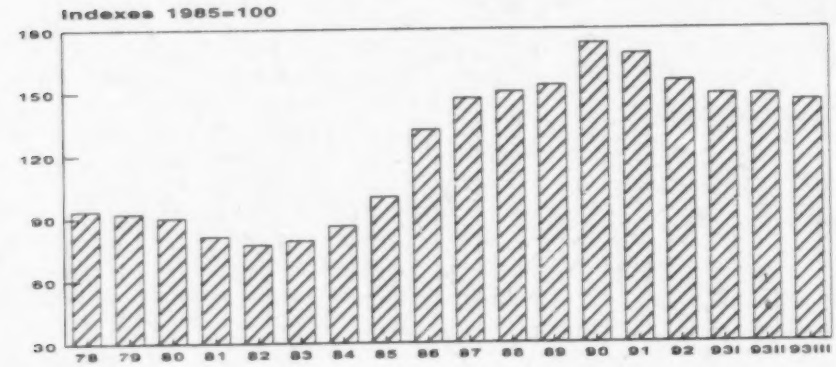
83 In January 1992, all exporters were allowed to keep part of their foreign exchange earnings abroad; formerly, only State enterprises exporting oil and minerals and coffee exporters had been permitted to do this; moreover, residents were allowed to keep assets of up to US$ 500,000 abroad without prior permission. In February 1992, Colombia reduced to one year the minimum maturity period for external loans, which had been five years with a two-year grace period. These loans are permitted only if their object is to finance working capital and fixed investment (IMF, 1993a).

Figure XI.4
INDEXES OF THE REAL EFFECTIVE EXCHANGE RATE FOR EXPORTS IN SELECTED COUNTRIES

COSTA RICA



COLOMBIA



ARGENTINA

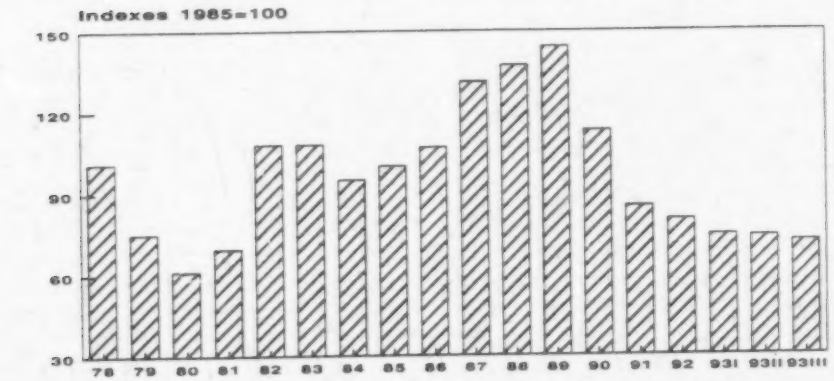
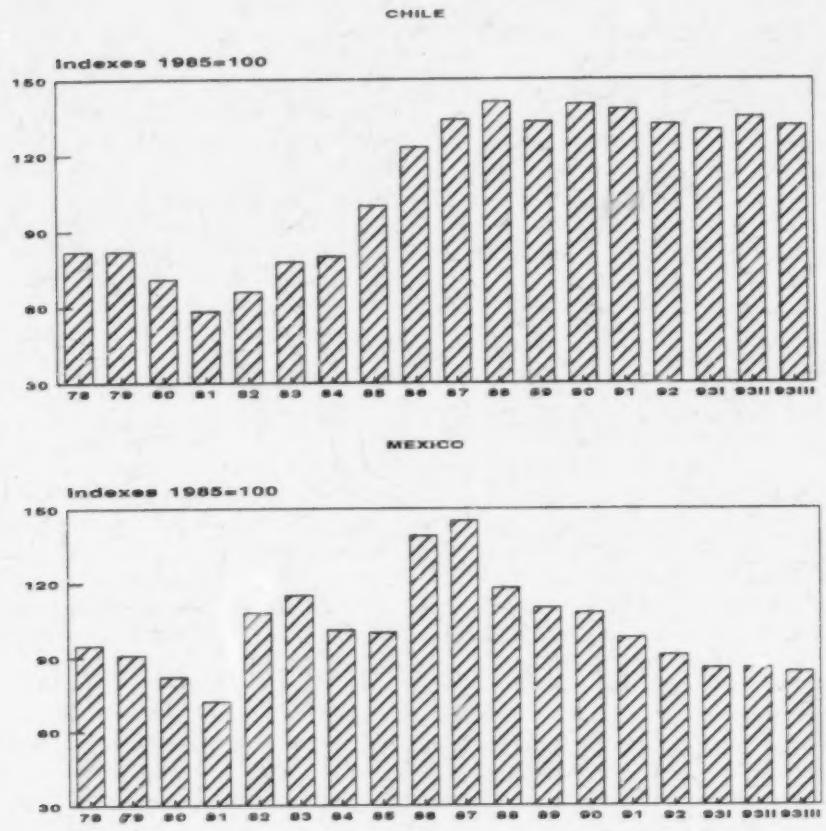


Figure XI.4 (cont.)



Source: ECLAC, on the basis of figures from the International Monetary Fund (IMF).

countries of the region as regards capital movements. As mentioned in earlier sections, in those countries the evolution of net capital movements has been relatively stable for the past three decades.[84]

One particular feature of the composition of these flows is the importance of official and private unrequited transfers. Official transfers accounted, on average, for 43% of capital movements in 1990-1992 and about 31% in 1980-1989, while private unrequited transfers (which are formally recorded in the balance-of-payments current account) accounted for 35% and 24% in the same periods.

In **the case of Costa Rica**, linkages with international financial markets also presented the features described above, although the proportion of unrequited transfers in total capital flows remained

84 On average, the net entry of capital as a percentage of GDP was 9.2% in 1977-1981, 7.6% in 1983-1989 and 9.4% in 1990-1992.

below the average for the subregion. Official unrequited transfers accounted for an average of 22% of capital movements in 1990-1992, while private transfers fluctuated around 11%. Compared with other countries of the subregion, Costa Rica used more macroeconomic instruments in the management of capital flows, the accumulation of reserves was significant and the composition and volume of the new flows was different.

In 1982, Costa Rica began a gradual process of economic reform, intended mainly to liberalize foreign trade, the financial system and exchange rate policy.[85]

Since the mid-1980s, Costa Rica has sought to encourage private participation in the financial market. In March 1992 it authorized commercial banks to acquire deposits in foreign currency (they had formerly done so on behalf of the Central Bank), to negotiate securities and to make loans in foreign currency. In late 1989, banks began to determine interest rates (which had traditionally been regulated by the economic authorities) freely and, since 1991, they have not been subject to restrictions as regards the allocation of credit (Rodríguez and Rodríguez, 1993).

In this context, in order to implement monetary policy, the Central Bank had to resort mainly to open market operations and to establishing minimum legal reserve requirements on current account and time deposits in local and foreign currency.

As regards exchange rate policy, after using a crawling peg exchange rate for a time, in early 1992 Costa Rica established a system of free floating (so that the market would determine the exchange rate level);[86] banks and other institutions were allowed to buy and sell foreign exchange freely and all exchange restrictions on capital movements were eliminated.

After Costa Rica adopted the new exchange rate system, there was a tendency towards appreciation of the currency, which by June 1992 had risen 7.5% since the introduction of the free float at the beginning of that year. After that, the Central Bank began to intervene more actively, first, to try to reverse this trend and, second, to maintain a stable nominal exchange rate until June 1993. This resulted in a real appreciation of the currency from its 1991 level (Rodríguez and Rodríguez, 1993) (see figures XI.3 and XI.4).

Output growth was relatively high during 1990-1993 with an average annual rate of 4.6% (see table XI.6). Inflation (measured by the CPI) fell from 25% in 1991 to 17% in 1992 and 9% between October 1992 and October 1993 (ECLAC, 1993f).

Measured in constant 1980 dollars, the current account deficit, after dropping in 1991 to 3 percentage points of GDP, increased in 1992 to 7 points (lower than the figure for 1990). Domestic savings grew by nearly 6 points of GDP between 1990 and 1992, while total investment stayed at the same level (22%) (see table XI.6).

c) Reflections on the experience of countries

From the various experiences outlined above it can be seen that, in general, the renewed inflows of capital to the region in the 1990s have allowed countries to resume their economic growth. These developments have taken place in relatively more stable macroeconomic contexts than those of earlier decades, a fact reflected in the marked deceleration of the inflation rate.

Both in the countries reviewed and in the region as a whole there are significant trends towards exchange rate appreciation and growing deficits in the current and trade accounts of the balance of payments.

Countries which opted for moderate sterilization or non-sterilized intervention show marked appreciations in the ex-

85 Costa Rica also applied other reforms, such as price liberalization, elimination of subsidies, fiscal adjustment and special regimes designed to promote foreign investment.

86 The Central Bank preserved a degree of intervention through the direct sale and purchase of foreign exchange, which was reflected in a gradual accumulation of international reserves. In terms of months of imports, these totalled 3.5 and 5.5 months respectively in 1990 and 1992.

Table XI.6

LATIN AMERICA: INDICATORS FOR SOME COUNTRIES

(Percentages of GDP based on figures in 1980 dollars)

	1976-1981	1980-1981	1982	1983-1989	1990	1991	1992
Argentina							
Net inflow of capital	1.7	1.6	1.6	1.5	1.0	3.3	7.4
Variation in reserves	2.8	-2.5	-0.6	-0.4	2.4	1.6	2.6
External savings	-1.1	4.2	2.2	1.9	-1.3	1.7	4.8
Effect on recovery							
Rate of variation of GDP	3.9	-1.4	-3.1	0.1	-0.1	8.9	8.6
Goods imports	5.2	7.9	4.8	4.0	3.0	4.9	8.2
Investment	25.2	23.7	19.2	17.0	13.3	15.3	18.5
Per capita GDP (1980 dollars)	3 932	3 961	3 641	3 599	3 278	3 527	3 787
Medium-term effect							
Domestic savings (GDP-C)	28.6	22.3	25.0	24.2	26.6	23.5	22.1
National savings (Y-C)	26.3	19.6	17.0	15.1	14.7	13.6	13.7
Goods exports	8.3	7.8	8.7	9.7	14.9	13.5	12.4
Non-financial external balances							
Non-financial trade balance current account (X-M Gs and Ss)	3.4	-1.4	5.8	7.1	13.3	8.2	3.6
Chile							
Net inflow of capital	6.1	15.5	4.3	4.7	7.9	3.6	8.0
Variation in reserves	2.0	2.7	-5.6	0.3	6.0	3.2	5.8
External savings	4.2	12.7	9.9	4.4	1.9	0.4	2.2
Effect on recovery							
Rate of variation of GDP	8.2	6.6	-12.6	5.0	2.0	5.8	10.3
Goods imports	17.6	22.7	16.1	16.1	19.6	19.7	22.1
Investment	14.1	22.2	11.5	14.5	18.1	17.4	20.1
Per capita GDP (1980 dollars)	1 998	2 235	2 072	2 652	2 599	2 705	2 936
Medium-term effect							
Domestic savings (GDP-C)	14.2	15.0	15.7	23.8	27.6	28.6	29.3
National savings (Y-C)	9.9	9.4	1.5	10.1	16.2	17.0	17.8
Goods exports	18.9	17.1	21.5	24.9	26.9	27.3	28.3
Non-financial external balances							
Non-financial trade balance current account (X-M Gs and Ss)	0.1	-7.2	4.2	9.3	9.6	11.2	9.2
Colombia							
Net inflow of capital	2.5	4.5	6.0	2.2	0.1	-1.0	0.6
Variation in reserves	3.9	1.4	-2.4	0.1	1.2	3.6	2.3
External savings	-1.4	3.1	8.4	2.1	-1.1	-4.6	-1.7
Effect on recovery							
Rate of variation of GDP	5.7	3.3	1.0	4.2	4.0	1.9	3.6
Goods imports	11.0	13.4	15.1	10.9	10.2	8.7	10.7
Investment	18.3	20.1	22.0	17.5	14.9	14.4	16.1
Per capita GDP (1980 dollars)	1 138	1 308	1 213	1 445	1 444	1 447	1 473
Medium-term effect							
Domestic savings (GDP-C)	19.4	18.2	17.0	20.0	22.2	22.8	22.0
National savings (Y-C)	19.7	17.0	13.6	15.4	15.9	19.1	17.9
Goods exports	11.9	11.5	10.1	13.3	17.2	18.6	18.1
Non-financial external balances							
Non-financial trade balance current account (X-M Gs and Ss)	1.1	-1.9	-5.0	2.5	7.3	8.4	5.9

Table XI.6 (concluded)

	1976-1981	1980-1981	1982	1983-1989	1990	1991	1992
Costa Rica							
Net inflow of capital	14.8	15.6	11.9	11.3	7.1	9.3	9.9
Variation in reserves	1.1	0.7	3.7	2.1	-3.8	6.3	2.4
External savings	13.7	15.0	8.1	9.2	10.9	3.0	7.4
Effect on recovery							
Rate of variation of GDP	6.5	-0.9	-7.3	4.2	3.4	2.1	7.2
Goods imports	41.5	34.6	24.7	32.4	38.5	33.7	40.8
Investment	24.3	21.6	13.6	21.2	22.8	19.2	22.0
Per capita GDP (1980 dollars)	1 526	1 389	1 325	1 459	1 462	1 455	1 522
Medium-term effect							
Domestic savings (GDP-C)	11.9	18.0	26.3	27.7	31.4	36.2	37.1
National savings (Y-C)	10.7	6.9	5.5	12.0	11.8	16.3	14.6
Goods exports	31.5	30.4	31.9	33.8	39.6	40.7	46.8
Non-financial external balances							
Non-financial trade balance current account (X-M Gs and Ss)	-12.4	-3.8	12.7	6.5	8.6	17.0	15.1
Mexico							
Net inflow of capital	3.2	7.6	1.4	-0.4	4.7	8.4	8.9
Variation in reserves	0.1	0.5	-1.8	0.1	1.3	3.1	0.4
External savings	3.1	7.1	3.1	-0.4	3.4	5.3	8.5
Effect on recovery							
Rate of variation of GDP	7.3	9.0	-0.6	0.7	4.4	3.6	2.6
Goods imports	6.9	11.3	7.4	8.1	14.5	16.3	19.9
Investment	23.0	27.9	21.8	17.0	18.9	19.5	20.7
Per capita GDP (1980 dollars)	2 275	2 462	2 703	2 473	2 456	2 491	2 503
Medium-term effect							
Domestic savings (GDP-C)	24.6	25.0	27.4	27.0	24.1	23.1	20.4
National savings (Y-C)	19.9	20.9	18.7	17.4	15.5	14.2	12.2
Goods exports	6.8	9.3	12.5	16.2	17.4	18.2	18.1
Non-financial external balances							
Non-financial trade balance current account (X-M Gs and Ss)	1.6	-2.9	5.5	10.0	5.2	3.6	-0.3

Source: ECLAC, Statistics and Economic Projections Division, on the basis of official data.

change rate, greater increases in the deficit on the current and trade accounts, reductions or moderate increases in national savings and successes in combating inflation.

Countries which adopted active intervention policies show increases in levels of national savings, a more moderate trend towards exchange rate appreciation and relatively smaller current account deficits. The reduction in the rate of inflation is also more moderate than in the other cases.

The experience of the region, particularly in the past decade and a half, shows that one of the main requirements for ensuring that external capital inflows will boost medium- and long-term growth is that countries must be able to maintain conditions of macroeconomic stability which support efforts to change production patterns and improve international competitiveness. Accordingly, experience suggests that the success of economic policy must be measured in terms of the ability to simultaneously secure a permanent inflow of capital, maintain a degree of control over exchange rate and monetary policy and increase national savings and investment, which must go to support the productive base —for tradables and non-

tradables— in order for the country to compete internationally.

A careful measure of sterilized intervention and regulation of short-term capital inflows is usually needed for this. In general, intervention schemes have been applied at three levels: i) intervention in the foreign exchange market, through floating of the exchange rate within predetermined bands; ii) sterilization of the monetary effects of the greater availability of foreign exchange; and iii) regulation of short-term speculative capital movements through reserve requirements, quotas and commissions.

The experiences just analysed illustrate the importance of having instruments which can be adapted rapidly and flexibly to the conditions of the economy. The object is that such instruments should allow regulations to be introduced to: i) isolate the money and foreign exchange markets from short-term speculative international capital movements; ii) permit the administration of monetary policy when capital inflows cause changes in the monetary base which generate excess demand; iii) discourage capital outflows to international markets in periods of external constraint, neutralizing the effect of short-term factors which do not respond to medium- and long-term trends; and iv) equalize the cost of access to external capital, so as to avoid the debt overhang of the private and/or public sectors and the possible emergence of destabilizing bubbles.

Intervention also has its risks, however. Excessive restrictions must be avoided because: i) an overabundance of regulations creates uncertainty, which generally discourages productive innovation; ii) regulations which persistently go against market forces end up being infringed and lead to the emergence of parallel markets; iii) if norms are overly restrictive they also limit the range of risk, liquidity and due dates available to creditors and debtors; iv) they reduce the opportunities available to financial institutions oriented to the international market; and v) they could limit economic growth by cutting the country off from major possibilities of obtaining financing for growth and for cushioning short-term, transitory stocks.

Chapter XII

REGULATION, SUPERVISION AND STABILITY OF FINANCIAL INSTITUTIONS AND CAPITAL MARKETS

The liberalization of the balance of payments capital account described in previous chapters is generally carried out in the broader context of financial —and indeed economic— deregulation designed to emphasize the market context in the determination of key prices of the economy. Whatever the rate and content of financial liberalization, however, paradoxically it requires regulatory and supervisory bodies in order to be successful in terms of the credibility and solvency of financial institutions and capital markets.

The dominant position which the banks occupy in domestic financial systems means that the deregulation of credit, interest rates and procurement of funds by banks has a salient role in these policies. Since the mid-1980s, a number of Latin American countries have extended the scope of financial reforms to cover the stock markets too. In some cases, the rise of institutional investors has played an important role in the development of the stock market and capital formation. From the 1990s onward, in this group of countries, the inflow of international funds through portfolio investments has also encouraged emerging stock markets.[87]

This chapter will analyse the significance and role of some of the main determinants of the activities of financial institutions and capital markets: the regulations and norms which fix the rules of the game, or the institutional framework of the participating agents as regards the procurement, intermediation and allocation of funds, and the supervision of effective compliance with them.[88] The chapter focuses in particular on regulation and supervision aimed at ensuring solvency and creditworthiness. The pertinent norms are particularly important in the various efforts at financial liberalization on the domestic market and the opening of the capital account.

1. Regulation and supervision of financial institutions and capital markets

There are three basic types of regulations and norms which affect the solvency and efficiency of financial institutions and capital markets: financial, organizational and prudential (Marshall, 1991).

87 A more detailed analysis of policy proposals concerning the regulation, supervision and stability of financial institutions and capital markets in Latin America and the Caribbean may be found in ECLAC reports, in particular Held (1993).

88 The solvency and efficiency of banks and financial institutions also depend to a very important extent on the following factors: macroeconomic conditions and policies, incentives for saving and capital formation, and the portfolio management of the institutions themselves.

a) Financial regulation

At the macroeconomic level, financial regulations are concerned mainly with the control of monetary aggregates, or of aggregate expenditure, with a view to stabilizing price levels and achieving a high rate of economic activity. Macroeconomic policies with these same aims formed the central theme of chapter XI. These financial regulations can influence the two key financial prices: interest rates and the exchange rate. As pointed out in the previous chapter, the regulations may establish bands for these values, or rules governing their behaviour, or they may fix one or both of these key prices. They may influence these values indirectly through rules affecting the availability and cost of funds by imposing restrictions on access, reserve requirements and taxes. Rules governing the inflow and outflow of national capital, whether foreign or domestic, form part of these regulations. At the sectoral level, financial regulations may influence the allocation of funds through preferential or selective rules favouring certain agents, activities or productive sectors.

Financial deregulation seeks to extend the scope of the market in determining interest rates, the exchange rate, and the acquisition and allocation of funds at the microeconomic level. In this context, financial liberalization is a broad deregulation policy which usually forms part of market-oriented reforms. The greater the extent of financial regulation, the more need there is to strengthen prudential regulation, as discussed later in this chapter.

b) Organizational regulation

Organizational rules are mainly designed to promote the efficiency of financial institutions and capital markets. In this sense, efficiency means both the operational efficiency of the institutions and the allocation of funds to investment projects and other socially profitable schemes.

Operational efficiency is characterized by the provision of financial services at minimum cost in terms of real resources, reflected on the one hand in a limited spread between the interest rates on loans and deposits fixed by banks and other institutions engaged in intermediation and, on the other, reasonably low commissions charged by other institutions and agents offering financial services. The attainment of operational efficiency requires rules that allow full use of the installed capacity of the financial institutions and the achievements of economies of scale and cost advantages derived from the provision of complementary financial services.

The attainment of efficiency in the allocation of funds to finance projects and other uses depends both on the macroeconomic conditions (especially the generation of appropriate signals with respect to profitability through the exchange rate and the price system) and on suitable financing conditions as regards interest rates, terms of payment and other elements. To achieve this effect, the organizational and prudential rules must allow for the development of financial institutions and instruments which make it possible to pool savings which are individually of small size compared with the projects they finance, to extend or modify the terms applicable to the funds (which are generally longer in the case of loans or financing than in operations involving the procurement of deposits) and to diversify the provision of financial services as regards loan and deposit operations.

Organizational deregulation seeks to amplify the range of transactions and financial services with a view to taking advantage of the diversification and "de-specialization" currently characterizing the development of capital markets. A typical example is the development of a specialized commercial bank into a multibank or a universal bank. The distinctive feature of the restoration of organizational regulation, for its part, is the reduction of the range of transactions and financial services which each institution can engage in, with a view to establishing specialized financial undertakings such as, for example, agricultural banks and savings and loan associations for housing.

c) Prudential regulation

Prudential regulation is aimed mainly at ensuring the solvency of banks, funds, insurance companies and other agents which manage the resources or assume the risks of third persons on a large scale. The discharge of these functions involves public confidence, for which reason the solvency or stability of financial institutions has important macroeconomic externalities.

Prudential norms have two distinct aims. The first is to give "transparency" to the solvency of the financial institutions and other agents issuing bonds and securities, the latter being transferable on the stock exchange. The attainment of the aim of "transparency" requires the provision of true, timely and sufficient information about the institutions' capital, results and other evidence of their ability and intention to fulfil, under the agreed conditions, the payment obligations laid down in the bonds and certificates. The second aim is to control the risks of loss which the financial institutions can assume. The attainment of this objective requires precise definition of the financial services they can provide, the restrictions and prohibitions affecting their activities, and the capital requirements for carrying them out. Clear identification of the risks, assets and results deriving from the provision of different financial services is essential in order to preserve transparency and avoid conflicts of interest among the parties, when institutional development or organizational deregulation extend the field of activities of financial institutions.

Prudential deregulation is characterized by relaxation of the controls designed to ensure the solvency of financial institutions. If this process goes too far, the result is "decontrol", in which there is a notable lack of rules on the proper handling of information and the limitation of risks. Prudential regulation, in contrast, strengthens controls aimed at ensuring solvency. Such regulation involves a special effort to encourage the active participation of the suppliers of funds to financial institutions in the control of risks to which the latter might be exposed. Prudential regulation has been growing in importance at the international level, especially as economies have become more liberalized.

d) Supervision

Effective supervision is decisive in ensuring that banks, financial institutions and other agents operating in capital markets observe the financial, organizational and prudential rules governing transactions and the provision of services. According to the level of these markets, and the policy for their development, such supervision will involve one or more specialized authorities of the public sector.

The distinguishing feature of prudential supervision of financial institutions is the periodic verification of the correct valuation of their portfolios of financial assets (loans or investments, as the case may be), bearing in mind the various risks involved, followed by the publication of simple solvency indicators which are easily understandable by depositors, savers and financial investors.

The limited development of the credit and capital markets of many Latin American and Caribbean countries shows that the role of the authorities responsible for regulating the financial system cannot be confined to the supervision of existing rules. One of the main tasks of these authorities is the introduction or modernization of norms of organization and solvency aimed at new institutions and financial instruments, in order to meet the requirements involved in the procurement, intermediation and allocation of a growing volume of funds.

2. Prudential regulation and supervision of the banking system

In view of the financial fragility of banks, due to their distinctive characteristics, prudential regulation and supervision are essential. The first of these characteristics is the high leverage of their financial structure: the ratio of liabilities (deposits and other obligations) and assets (loans and

investments) to capital is very often 10 or more to one. The second characteristic is the fact that banks acquire funds from third persons by issuing certificates of deposit and other obligations. With these resources they extend loans and make "own-account" investments, assuming various risks of loss of their capital and other funds. The loss or devaluation of part of their portfolio of loans and investments could therefore severely jeopardize their solvency.

a) Norms for regulation and supervision to ensure solvency

Table XII.1 shows how important it is for banks to assume risks compatible with their high levels of leverage. Since making loans to companies and individuals is the banks' main type of activity, the credit risk, or risk of non-payment under the conditions stipulated when the loan was signed, is the most typical risk assumed by banks. The table also refers to the following types of risks: exchange rate risk, arising from the making of loans or investments in a currency different from the assets used to finance them; the interest-rate and liquidity risk, arising from loans and investments entered into on terms that are longer than the assets used to finance them; and the risk caused by the concentration of loans and investments in certain agents, sectors of activity or geographical areas, because this could involve inappropriate portfolio diversification.

If the condition of transparency of the bank's situation of solvency is not fulfilled, the depositors will not be able to play their role as market controllers. Moreover, lack of transparency will give depositors and other bank creditors the idea that there is an implicit State guarantee for deposits and other obligations: i.e., that the public sector will be liable in case of insolvency, even though there may be no written rule to this effect.

b) Alternative systems of prudential regulation and supervision

The norms aimed at ensuring solvency (see table XII.1) and the system for guaranteeing and insuring deposits and other obligations constitute the two main components of bank regulatory and supervisory machinery.

Prudential regulation and supervision of banks becomes very important in the application of policies for financial and organizational deregulation. In this case, the liberalization of interest rates, the exchange rate, credit and other financial variables and the extension of the banks' activities to new financial services broaden the area in which they must take decisions on the allocation and acquisition of funds and expose them to a number of risks.

When this process takes place in the context of a "decontrolled" banking system, or when solvency is not subject to public controls, financial liberalization may lead to excessive indebtedness of non-financial enterprises, a high proportion of loans which are difficult to collect, and losses which severely undermine the banks' capital. A banking system whose solvency is not subject to controls will be tempted to make high-risk loans, often at high real interest rates. An explicit or implicit State guarantee for deposits and other obligations facilitates this process, and the perception of safety and the existence of attractive rates of interest on deposits gives an excessive stimulus to investors of national and foreign funds.

3. Regulation, supervision and financial instability in countries of the region

a) Shortcomings in prudential regulation and supervision as a factor of financial instability

Table XII.2 presents a sample of countries of the region in which various financial policy exercises led to problems of solvency in the last two decades. These problems were due, in particular, to two factors. Firstly, to serious faults in regulation and prudential supervision, arising from shortcomings in risk control, unsuitable rules concerning capital and reserves, weak supervision, or supervision re-

Table XII-1
PRINCIPLES OF PRUDENTIAL BANKING REGULATIONS

Objective of regulations	Content
Several entry requirements	- High minimum entry capital - Requirements concerning the suitability of the main shareholders, directors and general manager
Risks of excessive leverage	- Wide diversification of the loan and investment portfolio (so as to avoid concentrating the risk in certain agents, economic sectors and financial instruments) - Written rules on the granting of loans and the constitution of guarantees (with a view to controlling the credit risk of individual loans, especially "related" loans to shareholders, directors and managers of the banks) - Limits on inconsistency of terms between assets and liabilities (in order to control the interest-rate risk) - Limits on inconsistency between the currencies of assets and liablities (in order to control the exchange rate risk) - Limits on investment in fixed or immobilized assets and requirements for holdings of liquid financial instruments (in order to control the liquidity risk) - Control of other risks affecting banks [a]
Full anticipation of all measured risks of loss	- Careful measurement of all the risks of loss in the asset portfolio - Constitution of reserves so as to cover all risks of loss - Suspension of interest due on high-risk loans
Solid capital bases	- Rapid renewal of expected capital losses - Minimum capital requirements commensurate with the risks inherent in different types of assets
Transparency of the banks' solvency situation	- Provision of periodic information to depositors and the public about the banks' solvency situation, in the form of simple indicators of risks and reserves, capital or net worth
Orderly withdrawal from the banking system	- Orderly liquidation of insolvent banks - Rules on the order of precedence in the payment of given deposits and obligations (such as current accounts, savings deposits and Central Bank credits, etc.)

Source: ECLAC, on the basis of case studies of the Joint ECLAC/UNDP Regional Project on Financial Policies for Development.

[a] Refers mainly to "off-balance" risks, or risks not located in the loan and investment portfolio.

stricted to accounting and financial aspects, or explicit or implicit State guarantees on deposits and other obligations. These conditions meant that nearly all the exercises came within the institutional framework most liable to generate problems of insolvency: lack of bank controls or of controls on solvency. Secondly, these problems were due to macroeconomic conditions that were unstable or subject to severe maladjustments, with big changes in levels of economic activity, relative prices and personal and corporate income, which, by affecting the primary source of loan payments or the value of guarantees (the second source of repayment) bring down the quality of the banks' loan portfolios.

From the mid-1970s onward, Argentina, Chile and Uruguay applied liberaliza-

Table XII.2

BANK SOLVENCY PROBLEMS IN LATIN AMERICA AND CARIBBEAN COUNTRIES OVER THE LAST TWO DECADES

Country	Period	Financial regulation	Macroeconomic conditions	Prudential regulation and supervision	Stability of financial system	Finacial prices
Argentina	1974-1981	Liberalization of interest rates and credit. Opening of capital account.	Fiscal deficit and high inflation. Stabilization based on exchange rate (1978-1981).	Serious failures.	Financial crisis of banking system.	High real rates of interest. Exchange rate lag.
Chile	1974-1982	Liberalization of interest rates and credit.	Structural reforms and financial adjustment of the public sector. Stabilization based on exchange rate (1978-1982). Heavy external indebtedness.	Serious failures.	Generalized banking crisis.	High real rates of interest. Exchange rate lag.
Uruguay	1974-1982	Liberalization of interest rates and credit. Opening of capital account.	Maladjustment of trade balance. Stabilization based on exchange rate (1979-1982).	Serious failures.	Financial crisis of banking system.	High real rates of interest. Exchange rate lag.
Colombia	1979-1982	Sectoral credit limits. Cautious management of external indebtedness.	Relatively stable macroeconomic conditions.	Serious failures.	Financial crisis of banking system.	Fragmented interest-rate structure.
El Salvador	1980-1989	Sectoral credit allocation. Fixed interest rates.	Substantial fiscal deficit. Inflationary pressures.	Serious failures.	Financial crisis of banking system.	Financial repression of banking system.
Dominican Republic	1982-1990	Sectoral credit limits and fixed interest rates.	Fiscal imbalance. Growing inflation.	Serious failures.	Financial crisis of the unregulated financial sector.	Financial repression of regulated banks. High rates of interest in the unregulated sector.
Costa Rica	1983-1987	Gradual liberalization of interest rates and credit.	Stabilization and adjustment of the balance of payments.	Substantial improvements in prudential regulation and supervision.	Financial crisis of unregulated finance companies.	High real rates of interest in the unregulated sector.
Bolivia	1985-1990	Liberalization of interest rates and credit.	Stabilization and structural adjustment after high fiscal deficits and hyper-inflation.	Serious failures.	Isolated bank failures.	Decline in very high real interest rates.
Peru	1990-1992	Liberalization of interest rates and credit.	Stabilization and structural adjustment after high fiscal deficits and hyper-inflation.	Defects in regulations governing capital and reserves.	Solvency problems in the banking system.	Slow decline in very high real interest rates.

Source: ECLAC, *Regulación, supervisión y estabilidad de las instituciones financieras y los mercados de capital en América Latina y el Caribe* (LC/R.1358), Santiago, Chile, December 1993.

tion policies in respect of the exchange rate, credit and other financial variables, including the expansion of banks' activities under conditions very unfavourable to their solvency and stability. The simultaneous application of vigorous stabilization measures —especially the adoption of a fixed nominal exchange rate as a stabilization anchor in the three countries from 1978 onwards— and the adoption of structural reforms linked to foreign trade and the opening of the current account led to inconsistencies in economic policy and macroeconomic instability, while excessively low real exchange rates, high real interest rates and major changes in the profitability of economic activities affected the quality of the banks' loan portfolios (ECLAC, 1984b; Corbo, de Melo and Tybout, 1985, Ramos, 1986).

Furthermore, these liberalization processes took place in banking systems which lacked appropriate solvency controls. In all three countries there was an explicit or implicit State guarantee on deposits and other obligations and serious shortcomings in the rules controlling risks and reserve requirements. In Uruguay there were no minimum standards (Banda, 1990); in Chile the classification of loan portfolios by risk categories was begun only very shortly before the outbreak of solvency problems in the early 1980s (Held and Szalachman, 1989); and in Argentina banking supervision was practically non-existent and measurement of portfolio risks began only after the bank interventions of the early 1980s (Salama, 1991).

In the Southern Cone countries, the banking systems' loan portfolio underwent an abnormal increase in relation to GDP and other aggregate indicators of economic activity. Five years after the beginning of the liberalization processes, credits continued to grow at a rate 5 or 6 times that of GDP. This process was characterized by the liberal granting of high-risk loans, i.e., credits to non-tradable activities (including real-estate and speculative loans), financed largely with foreign debt, widespread rolling-over of loans at high real interest rates (accruing interest that in practice was not paid), and "related" credits which had few real guarantees.

Although it is difficult to evaluate the relative importance of macroeconomic instability and of the shortcomings in regulation and supervision of solvency in the widespread financial crises which occurred in the Southern Cone countries in the early 1980s, there is no doubt that these factors played a very important role. Significantly, both in Argentina and Chile, and partly in Uruguay, the banks' severe solvency problems occurred before the external debt crisis brought about substantial declines in the levels of economic activity in the three countries.[89]

The banking crisis in Colombia at the beginning of the 1980s illustrates how banks which do not impose solvency controls can take high credit risks and suffer unsustainable capital losses even in relatively stable macroeconomic conditions and within the framework of a conservative policy as regards access of banks to external indebtedness. Bank loans experienced a "bubble" in 1980-1981, when they shot up over 40% in real terms. The widespread bank intervention initiated in 1982 showed the undesirability of granting "related" high-risk loans to economic groups, including the use of bank loans to buy shares in non-financial enterprises, in this time of abnormal growth. The credit norms and limits were greatly exceeded, while the supervisory authority lagged behind in verifying the quality of the loan portfolio (Zuleta, 1990).

Bolivia (1985) and Peru (1990) liberalized interest rates and credit in a context of considerable macroeconomic turbulence and severe stabilization and structural adjustment policies characterized by rapid price liberalization, opening-up of the economy, and drastic fiscal adjustment. Uncertainty over the behaviour of prices triggered a sharp increase in

89 The severe contraction in economic activity and the substantial devaluations which brought on the crisis also caused a decline in the quality of the banks' loan portfolios.

interest rates. In Bolivia, real annual interest rates on bank loans amounted to about 100% in 1985, 40% in 1987 and 20% in 1989-1990 (Afcha de la Parra, 1990), while in Peru the initial increase in interest rates was greater and its decline slower, so that in the first quarters of 1991, 1992 and 1993 real annual interest rates were around 170%, 50% and 35% respectively (Banco Central de Reserva del Perú, 1993a).

Interest rate trends and the fluctuations in relative prices and in the profitability of economic activities, due to stabilization and macroeconomic adjustment, appear to have been the main factors behind solvency problems in the banking systems of Bolivia and Peru. However, defects in the regulation and supervision of solvency also contributed to this problem.

The closure of four banks in Bolivia in 1987 revealed the lack of appropriate solvency controls, i.e., shortcomings in risk-limiting norms, excessive "related" loans, weak supervision and an implicit State guarantee for deposits.

In Peru, prudential regulation improved considerably with the classification of bank credit in risk categories and the explicit limitation of State guarantees on deposits (1991) through the introduction of an insurance system with limited coverage, financed with premiums paid by the banks, and the provision of public information on the quality of bank portfolios (González Arrieta, 1992). From 1991 onwards, the failure of a number of banks and mutual funds exhausted the insurance fund and the State had to cover the deficit. In March 1993, unpaid loans owed to the commercial banks represented 22% of their credit portfolios, but their reserves amounted to only 12%. This situation indicates a shortage of reserves (*Banco Central de Reserva del Perú*, 1993b). Another factor in the emerging solvency problems was the erosion of the technical staff of the supervisory authority, due to the severe cuts in public expenditure.

b) Recent reforms in bank regulation and supervision

The cases of financial instability already mentioned and the policies of reform and liberalization of the financial system being applied in most countries of the region have encouraged the strengthening of bank regulation and supervision systems, especially from the mid-1980s onward.

The reforms in the area of prudential regulation and supervision have emphasized both solvency control by the supervisory authority and the importance of explicitly defining and limiting State guarantees and the insurance of deposits. The first course of action has led to the limitation of portfolio risks, especially those associated with "related" credits; the breakdown of the loan portfolio by risk categories; the adoption of stricter norms on reserves, with, in some cases, the establishment of minimum capital requirements according to the risk of the various categories of assets (such as those provided for in the Basle Agreement), and the strengthening of the executive and technical capacity of the supervisory body.[90]

90 The Basle Agreement is based on the assumption that a bank's strength and safety depends mainly on the size of its capital base. The Agreement assigns to each class of asset, as well as to assets and liabilities that do not figure in the balance-sheet, a weighted risk which varies between zero and 100%, depending on the relative credit risk, for the purpose of deciding levels of capital. With a view to establishing convergence of the capital needs of the banks between different countries, the ratio between the capital and the off-balance-sheet items (converted into credit equivalents) and weighted by the risks involved must attain 8% by the end of 1992 (Cornford, 1993). With regard to the second course of action, six of the nine countries in the sample given in table XII.2 have adopted limited guarantees for deposits, while two others have decided not to maintain any system of protection (Comisión Nacional Bancaria de México, 1993). As for the second course of action, six of the nine countries included in the sample of table XII.2 have opted for limited deposit guarantees; others have decided not to maintain any protection system (Comisión Nacional Bancaria de México, 1993).

Notwithstanding these advances, it is only in a small number of countries that the reforms have provided depositors and other creditors with public information on the risk of loss of assets and the effective net worth of the banks. This leads to the question of whether there continues to be an implicit State guarantee for deposits and other obligations.

4. Regulation and supervision of institutional investors in the stock market

The acceptance of risks by those who provide funds for the stock market places them in a very different category from those who provide funds to banks (by means of deposit certificates and other obligations), since they accept credit, non-liquidity and other risks in acting as intermediaries. This difference has led to a system of stock-market regulation and supervision which emphasizes its transparency and the quality of the information made available to providers of funds (or those buying shares). The requisite of transparency is essential for the stability and efficiency of the stock market, and is more important than in any other market (Lavados and Castillo, 1993).

The efficiency of the stock market also depends on organizational norms which encourage competition and avoid or regulate the influence of certain participants, especially the big institutional investors (pension funds, insurance companies).

a) Norms designed to maintain the solvency of institutional investors

Their potential for acquiring resources gives institutional investors a determining role in the demand for securities and hence in the development of stock markets. Since they are dealing with the resources of third persons or with funds involving risks for third persons, the norms for prudential regulation and supervision must be very strict and must seek to attain the following common objectives for the various institutional investors:

i) Independence of capital and management between funds, their administrators, issuers of securities and intermediaries, on the one hand, and insurance companies, issuers of securities and intermediaries, on the other. The solvency norms must prohibit all property links or interrelations between their directors and must establish "firewalls" or divisions clearly indicating which transactions or operations are permitted and which are prohibited. These conditions are essential for ensuring that the funds are managed for the benefit of members or subscribers and for avoiding conflicts of interest among the various agents participating in the market and preventing transactions harmful to the capital or rights of the subscribers or insured persons.

ii) Provision of reliable, timely and sufficient information to the public concerning the profitability of funds and their net worth.

iii) Composition and diversification of the assets portfolio of institutional investors in conformity with the requirements of profitability, risk and liquidity established by the financial services which extend loans to their participants, subscribers or insured persons. This presupposes an adequate supply of securities and bonds with different terms and different profiles of profitability and risk.

Pension funds based on a system of individual capitalization tend to be the most important institutional investors on the stock market. This is because of the long period that elapses between the entry of the persons into the labour force and their retirement (usually 30-40 years) and the capitalization of funds during that period. Moreover, owing to the stable and long-term nature of the capital flows, pension funds are ideal for financing fixed capital formation (private housing investment, investment projects by big firms in various sectors).

The objective of accumulating resources in order to provide income for the retired population is reflected in prudential regulations which emphasize low-risk portfolios with a large share of fixed-in-

come securities (mortgages, and bonds issued by big firms and the public sector).

b) Reform of the pension system and development of the securities market in Chile

At the end of 1980, the Chilean authorities opted to replace the prevailing pensions systems based on shared distribution by a system of capitalization in individual accounts. At the end of 1992, the pension funds had resources equivalent to 34% of GDP, held nearly 60% of the mortgages and the bonds issued by big companies then in circulation, and more than 20% of the total universe of shares that could be purchased by these funds.

The substantial development of the Chilean stock market and its status as an emerging market are due mainly to domestic factors. Besides reforming its pension system, Chile privatized its public service enterprises or converted them into open limited companies, actively developed its stock market and achieved macroeconomic advances with recovery of GNP growth to an average of 6% in the period 1986-1993.

The rapid increase in the funds accumulated has raised a great challenge: that of giving a sound institutional structure to the capital market so as to channel funds to socially profitable uses through a range of financial institutions and instruments subject to strict norms of prudential regulation and supervision.

At the moment, a draft bill is under discussion which proposes substantial modifications to the rules governing the stock market in view of the concentration of pension funds in shares of privatized public services and the scarcity of financial instruments. However, further new institutional challenges are appearing on the horizon, including the regulation of financial conglomerates (Arrau, 1993).

The Chilean experience with a pension system based on individual capitalization has awakened interest in other countries of the region. Peru introduced a similar system in 1992, and Argentina, Bolivia and Colombia have reached an advanced stage with reform projects which also envisage capitalization options. In Brazil, El Salvador, Paraguay, Venezuela and other countries, studies are being carried out with a view to reforming existing pension schemes. As in Chile, the results achieved by the new pension schemes[91] will depend decisively on the institutional development of the national capital markets, including effective measures of prudential regulation and supervision.

5. Regulation of international portfolio investments

Since the beginning of the 1990s, a number of countries from the region have gained significant access to foreign capital through international portfolio investments (see chapter IX). This access has allowed the recipient countries to enjoy a larger supply of foreign exchange.

However, international portfolio investments also involve risks. From the viewpoint of the countries where the flows originate, their concern is with the systemic risks for their financial systems which can arise as a result of transfers to the developing countries. These are associated with i) the concentration of risk in a single creditor or investor; ii) the lack of experience of operators, intermediaries and investors in the proper evaluation of investment risks with regard to the opening-up of new areas of activity in the financial markets (for example, in stock markets, insurance markets and integrated financial markets where the problems in one segment may easily be

91 One unresolved aspect of Chile's pension reform is its net effect on national savings and capital formation. The flow of savings from the new system was a little more than 3% of GDP in the period 1990-1992. However, the net effect is difficult to gauge because of the deficit caused by the reform in the public sector pension system, which reached about 5% of GDP in that period, and the possibility that voluntary savings by families were crowded out by forced savings.

transferred to others); iii) the lags in institutional organization compared with advances in financial markets and the different speeds of such advances between countries whose financial markets are being integrated; and iv) the willingness of the economic authorities of the supplier countries to take responsibility in cases of liquidity and solvency problems, and the conditions on which such backing would be given.

a) Risks of international portfolio investors

Portfolio investors from the developed countries assume risks at two different levels in making portfolio investments in countries of the region and other developing economies: the country risks proper, and the credit risks of the domestic issuers of bonds and other debt securities.

The country risk involves a complex evaluation taking account of the following factors: the foreign-exchange risk or the probability that foreign investors will not have access to foreign exchange for the remittance abroad of commitments in respect of capital, interest and profits; the rate-of-exchange risk or the probability of having access to foreign exchange at a real rate of exchange substantially less favourable than at the time when the funds entered the country; the price risk or the probability that there will be an appreciable fall in the market price of the securities in which funds have been invested; and the liquidity risk, or the probability of having to trade securities from local issuers at a very early date, thus incurring a substantial loss of capital.

The qualification of country risk is an essential factor in the portfolio decisions of developed country investors who wish to purchase securities on the domestic markets of the issuers.[92]

The qualification of the credit risk of local private companies by international qualifying agencies is just as important as the evaluation of the country risk, or even more so, as a condition for enabling those companies to sell bonds and other debt paper on international markets. This process of qualification virtually began in the 1990s, together with the access of private firms of the region to international securities markets.

b) Risks of the country receiving international portfolio investments

As already noted with regard to regulation and supervision aimed at ensuring bank solvency, an implicit State guarantee for its deposits and obligations appears to persist to a large extent among the countries of the region. This perception may also extend to the issue of bonds by firms with participation of the public sector in their equity and even to private firms, to the extent that the sale of their bonds abroad is subject to authorization by a public sector financial authority. Reduction or elimination of the credit risk of the issuer is reflected in overincentives for foreign portfolio investment in bonds and other debt securities, on both the foreign demand and the domestic supply side.[93] This may encourage external overindebtedness partly analogous to the overhang of external bank credits registered in the late 1970s and early 1980s in various countries of the region.

On stock exchanges where the price/profit ratios of shares are well below the level that should prevail over the medium and long term (i.e., in line with the "fundamental" profitability and risk variables), foreign investment in national shares may help to force up stock-exchange indexes and can benefit from this. The stock-exchange capital of the coun-

92 Qualification as a low-risk country is characteristic of developed nations and stock markets, since it presupposes the simultaneous attainment of favourable conditions with respect to all the risk factors indicated and the prospect that no adverse changes will occur which can negatively affect foreign investors.

93 For foreign applicants, the credit risk diminishes; for domestic suppliers, the interest rate at which they can sell their securities diminishes.

tries in the region with emerging stock markets (Argentina, Brazil, Chile, Mexico and Venezuela) increased by 320% in the period 1986-1992 and by some 170% in 1991 alone, in current dollar terms. The increases in stock-exchange capital in Mexico, Argentina and Chile were quite spectacular, amounting to 2,245% and 209%, 1,131% and 460%, and 660% and 104% in the same periods, respectively (Harper, 1992). Indeed, it was in 1991, when the net inflows of foreign capital quadrupled in relation to 1983-1990, that the stock-market indexes registered their most spectacular increase (see chapter IX).

In Mexico, and also in Argentina, the sale of shares on international markets has given a boost to the local stock markets, along with the privatization programmes of public service enterprises, and financial reform and economic adjustment policies. In Chile, foreign investment funds have acquired a good deal of importance on its stock exchange, although it was the pension reform scheme and other domestic factors already mentioned which had most influence on the country's development.

c) Financial and prudential regulations aimed at international portfolio investments

The financial opening of the capital account to international portfolio investments in countries with emerging stock markets raises the risk of external overindebtedness in respect of bonds and other short-term debt securities tradable on the stock exchange and possible unjustified stock-exchange and exchange-rate fluctuations. Heavy inflows of foreign capital on national stock exchanges may at the same time provoke a stock-exchange "bubble" and increases in the exchange rate. The subsequent fall on the stock exchange may, in its turn, produce a flight of capital and pressures to devalue the exchange rate (Akyüz, 1993).

Financial and prudential regulation can counter these risks and help in the orderly and stable acquisition of international portfolio investments. Table XII.3 shows the content of a set of norms destined to regulate these international investments.

6. Conclusions and policy recommendations

a) In the last two decades the experience of countries of the region with different financial policies has shown the decisive influence exerted by regulation and supervision on the solvency and operating efficiency of financial institutions and on the efficiency of allocation of funds by capital markets.

The regulation and supervision of banks, financial funds, insurance companies and other financial institutions is important under any type of financial policy (liberalization, repression or free financial systems). Its role is especially distinctive and crucial, however, in the context of liberalization policies (extensive deregulation of interest rates, the exchange rate and conditions of access to funds in the national and international market). Liberalization usually considerably increases the volume of funds mobilized by financial institutions. At the same time, it exposes them to various risks within the broader context in which decisions on the acquisition and allocation of funds (credit and liquidity risks, exchange risk, etc.) must now be taken.

The above calls for the adoption of various measures of regulation and supervision, which are essential to strengthen the market economy.

i) Introduction and development of new financial institutions and instruments, or expansion of the range of activities of existing institutions, in order to facilitate the accumulation of funds, the modification of terms and currencies, and the diversification of risks, with due regard for the considerations of profitability, risk and liquidity demanded by providers and users of funds in respect of bonds and other securities.

ii) Strengthening of prudential regulation and supervision aimed at ensuring

Table XII.3
REGULATION OF INTERNATIONAL PORTFOLIO INVESTMENTS

Objective of regulations	Content
To check any tendency towards external overindebtedness through the issue of securities	- Explicit elimination of State guarantees for the sale of bonds by private companies on international stock markets
	- Clear rules for, and limitation of, State guarantees for the sale of bonds by public companies on international stock markets
	- Requirement for express authorization by the financial authorities of the sale of bonds and other debt certificates by public institutions and firms to international portfolio investors
To channel the external bond debt towards medium- and long-term securities	- Facilitation of the sale of medium- and long-term bonds on international stock markets by private companies, subject to the aforementioned conditions regarding guarantees
	- Restrictions on the entry of capital in respect of short-term bonds or certificates or speculative activities (reserve requirements, taxes or prohibitions)
To avoid stock market "bubbles"	- Granting of authorization for the sale of shares on international stock markets (through ADRs or the registration of issuers) only to national companies which fulfil the necessary requirements of transparency and solvency
	- Access of foreign investment funds or country funds to the domestic stock market permitted only on a gradual basis

Source: ECLAC, *Regulación, supervisión y estabilidad de las instituciones financieras y los mercados de capital en América Latina y el Caribe* (LC/R.1358), Santiago, Chile, December 1993.

the solvency of financial institutions, so as to limit and control the risks they can take in the provision of financial services, to give transparency to their results and capital situation, and to offer solid bases for their net worth or effective capital.

b) The financial experience of the countries of the region over the last two decades indicates that the macroeconomic situation has likewise exerted a decisive influence on the solvency and efficiency of financial institutions and capital markets. The price system —especially interest rates and the exchange rate—, growth prospects and current economic situation provide the financial institutions and economic agents with signals on the profitability and systematic risk of economic activities. Consequently, as with the regulation and supervision of the financial system, the macroeconomic situation exerts a decisive influence on the result of financial liberalization policies.

c) The severe solvency (and efficiency) problems suffered by the banks and credit institutions of a representative sample of Latin American countries since the end of the 1970s show the importance of regulation and supervision and of the macroeconomic environment. In all cases of financial crisis, there were serious failures in prudential regulation and supervision, and very often the macroeconomic situation was unstable, with the exchange rate and interest rates reaching excessive levels.

The institutional framework of regulation and supervision was usually that most likely to cause financial problems: in other words, the banking system lacked controls over its solvency on the part of both depositors and creditors and of the

government authorities. Merely deregulating the financial variables in this context constitutes a policy of financial "decontrol" rather than one of financial liberalization. A significant point that should be noted is that a "decontrolled" banking system generates or facilitates the outbreak of financial crises both in a context of financial liberalization and in one of financial repression with freely-operating financial institutions.

d) The deregulation of interest rates constitutes a distinctive measure within financial liberalization policies. The experience of the region indicates that, when interest rates rise excessively, under conditions of serious failures in prudential regulation and supervision or of strong inflationary pressures and macroeconomic maladjustments, they tend to remain at high real levels. Although there are various factors which can explain this situation, there is one which is particularly important from the standpoint of regulation and supervision: high real rates of interest which are due but unpaid encourage a process of rolling-over high-risk credits and interest commitments which rapidly "swells" credit and extends the solvency problems of the debtors to the financial institutions themselves.

e) The strengthening of prudential bank regulation and supervision in certain countries of the region, especially from the mid-1980s onwards, appears to be one of the main factors that has contributed to the solvency of their banks and credit institutions since then.

The classification of credit by risk categories, the system of reserves and capital requirements are the areas in which the greatest advances have been made. However, little information has been provided to depositors and the public about the risks of losses and the capital situation of banks and credit institutions. This has helped to maintain the perception of an implicit State guarantee for deposits and obligations, in spite of the suppression or limitation of explicit guarantees. This shows how important it is to keep on striving to improve rules designed to limit and control the risks of losses.

f) The mobilization of contractual savings, mainly through pension schemes based on capitalization of funds in individual accounts and insurance covering specific risks (unemployment, disablement, survival, etc.), represents an effective option for promoting the development of national stock markets. The speed with which institutional investors can accumulate funds brings out clearly the challenges facing the organizational and prudential regulation of the financial system. Failure to achieve the active development of financial institutions and instruments, including that of the public institutions responsible for regulation and supervision, could mean that the accumulation of funds by a rapidly growing financial system would be diluted in high-risk credits ("credit bubbles") and the encouragement of sharp rises in the prices of existing securities ("stock-market bubbles") and of real estate and other assets. Stable institutional development requires strenuous efforts on the part of the public authorities in the financial sector, so as to keep up with the capacity for accumulating funds.

g) Capital inflows in the form of international portfolio investments presuppose considerable development of the domestic stock market and clear rules on access to the foreign exchange market. These capital inflows can help develop local stock markets and real capital formation to the extent that they are motivated by medium- and long-term factors. The sale of shares on international stock exchanges by first-class private firms and the gradual incorporation of foreign investment funds into the national stock market are examples of international portfolio investments which satisfy this requirement.

So long as the perception remains that there is an implicit State guarantee in respect of debt securities, however, the entry of capital in the form of international portfolio investments will act as an overincentive and entail the risk of external over-indebtedness.

Chapter XIII

CAPITAL INFLOWS AND POLICY IMPLICATIONS: RECAPITULATION

The region's renewed access to international financial markets offers an opportunity to supplement domestic saving in order to meet the requirements of changing production patterns with social equity. It is especially important to promote investments that enhance the competitiveness of the region's economies and the well-being of its population.

International capital markets have grown dramatically since the mid-1960s. This growth can be seen partly from the fact that daily capital movements in international foreign exchange markets currently yield an average of nearly one trillion dollars. Thus, in a single day, total transactions exceed the annual GDP of many industrialized countries and amount to the equivalent of over a quarter of the annual value of world trade.[94]

Although international capital movements partly reflect expanding economies, increasing world trade and the globalization of production, they also involve purely financial factors. In the 1960s, the growing presence of little-regulated international offshore financial centres stimulated capital movements by enabling creditors and debtors alike to evade national financial regulations, capital controls and taxes. Then, in the 1970s and 1980s, many countries began to deregulate their domestic financial sectors and to relax or abandon the regulation of foreign exchange transactions. This, combined with revolutionary technological advances in the handling of information and telecommunications and the emergence of increasingly sophisticated financial engineering, contributed to a boom in both national and international financial flows.

It may be premature to speak of integrated financial markets, since international capital mobility is clearly far from perfect. Nevertheless, there is no doubt that international capital circulation and global financial integration are increasing steadily. These developments have aroused controversy. At one extreme, there are those who see increasing integration as a sign of greater efficiency; according to their interpretation, markets are overcoming the financial repression characteristic of inefficient governments. At the other extreme, there are those who see the boom in capital flows as a risky speculation that threatens national sovereignty. Of course, between these two extremes there are various intermediate positions which recognize the tremendous potential advantages of greater international capital mobility, but are also concerned about issues such as the composition and terms of capital flows and the need to ensure that they are compatible with macroeconomic stability, investment, growth, social equity and national autonomy.

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94 Global exports totalled US$ 3.7 trillion in 1992 (IMF, 1993b).

Recently, this controversy has assumed greater importance for Latin America and the Caribbean. It is true that, in the 1980s, the region's links with international capital markets were largely severed as a result of the massive debt crisis brought about by international commercial banks' permissive credit policies during the preceding decade. However, the region has enjoyed a renewed expansion of capital flows during the 1990s. In 1992 and 1993, average net capital inflows reached the unprecedented level of nearly US$ 60 billion a year (ECLAC, 1993f). These inflows are most welcome: their principal benefits include a reduction of the severe external constraint that was contributing to inflation and low investment levels and causing a severe economic recession in the region. Increased external saving, in so far as it supplements, rather than replaces, national saving, permits a higher rate of investment and growth. Nevertheless, these inflows have also had an unwelcome effect on the evolution of exchange rates, the degree of control over the money supply, asset prices, external liabilities and, possibly, future vulnerability to new external adjustments.

Financial markets play a number of important roles in development. Access to international financial markets offers the region's economies a way of attracting capital to activities that are highly profitable internationally. It helps international investors diversify risks. Unfortunately, international financial markets are also the markets that function most erratically in the economy. They have a long history of cycles of major expansion followed by varying degrees of contraction (Kindleberger, 1978).

The virtual stagnation of international capital flows between the Great Depression and the early 1960s is perhaps one of the best illustrations of the serious deficiencies in the functioning of international financial markets. Even when foreign capital inflows are maintained, short-term transactions may constitute an excessive proportion of such capital. Moreover, adjustments in the volume and prices of flows can be sudden and unpredictable.

From a public policy standpoint, the ideal solution would be to separate the permanent components of capital inflows from the temporary ones. If there is a permanent flow, such related phenomena as real exchange rate appreciation, growth of the current account deficit and increased consumption could be interpreted as stabilizing adjustments and, therefore, economically healthy. If, on the other hand, capital flows are temporary, the aforesaid movements in key variables would be distortionary, since they would create economic imbalances and the likelihood of disruptive future adjustments with a high social cost. This distinction is, of course, very difficult to make in practice. However, there are economic policy measures which can have a differentiated impact on short- and long-term flows or on flows of productive as opposed to purely financial investment.

The externalities and other major imperfections of international capital markets give rise, among other things, to frequent cycles of abundance and scarcity of resources and to systemic crises, with the result that even potentially permanent flows can disappear overnight (Guttentag and Herring, 1984). Accordingly, it is always advisable for governments to exercise a degree of caution where capital inflows are concerned, in order to promote a situation where their aggregate amount and main components are compatible with macroeconomic stability, investment, and growth based on international competitiveness. If the size and composition of capital flows are incompatible with these parameters, sooner or later their sustainability could be threatened, making it necessary to resort to inevitable, potentially destabilizing and socially costly national adjustments. This problem of domestic absorptive capacity is compounded by the inherent risks of any short-term external shock in international financial markets.

Since capital flows can affect, and are affected by, national economic variables,

governments should exercise caution on two fronts. First, they should avoid a situation where capital inflows create atypical values or major distortions in key national economic indicators, such as real exchange rates, domestic interest rates, sectoral and national indebtedness, inflation (including asset prices), consumption, investment and the production of tradables.

Second, governments should guard against using external capital flows as their main instrument for achieving a rigid or extreme target for a single domestic economic variable, especially over a prolonged period of time. Doing so could throw other important variables out of balance, thereby affecting the very instrument they tried to use in the first place, namely, external capital inflows.

Capital flows are not always compatible with the objectives of macroeconomic stability in its broad sense, sustained economic growth and social equity. A degree of direct or indirect public "management" in order to influence the volume and composition of these flows is therefore justified. There have been numerous past experiences —successful and unsuccessful— in applying this approach. What constitutes an appropriate degree of liberalization of the capital account could vary over time, depending on short-term domestic and international conditions and the level and needs of the development process.

With respect to the speed at which the capital account should be liberalized, in order to maintain a stable real exchange rate the process must be tailored to the economy's capacity to absorb and efficiently allocate external resources. For instance, a distinction could be made between capital inflows and outflows (Williamson, 1991). It could be desirable to liberalize long-term capital inflows first, before facilitating transactions in short-term financial capital. With respect to capital outflows, priority would have to be given to credits for export promotion and to direct investments abroad by national firms, which are another way of improving their export capacity.

Capital-account liberalization in the industrialized countries has been fairly slow and gradual, accelerating only in the past 10 years as capital markets have become globalized. However, it is interesting to note that Spain, Portugal and Ireland introduced certain restrictions on capital movements in 1992 to combat exchange rate instability. Once the objectives of stability were achieved, the restrictions were lifted. This highlights the importance of flexible instruments that, according to circumstances, allow some temporary constraints to be imposed on capital movements to support efforts towards macroeconomic stability.

In periods when resources are scarce, there would be justification for seeking specific and more general ways of attracting capital inflows and erecting certain barriers to capital outflows. The reverse would apply when there was an obvious abundance of capital in the markets: certain kinds of inflows would have to be restricted and it might be appropriate to promote some channels for capital outflows.

Using special instruments to manage capital flows obviously entails some costs. However, experience has shown that always leaving the market to determine the volume and composition of such flows may also entail major costs.[95] There is no instrument, or set of instruments, which can operate perfectly or with complete efficiency; in an imperfect world, instruments must be judged by their overall results. Pragmatic use must be made of the policy instruments that offer the greatest *net* benefits in terms of macroeconomic stability and growth, while minimizing costs.

The inflow of capital has had the effect of lifting the external constraint on growth and offers the opportunity to obtain financing both for reactivating economies

95 During the 1970s, most Latin American countries let the market determine the volume and terms of external credit, and we know what negative consequences this entailed.

and for maintaining the investments necessary for sustained and sustainable growth. To seize this opportunity, action must be taken on two fronts related to financial policy: i) the interaction of financial policy with macroeconomic policy to create a stable economic environment, with suitable incentives for economic agents: and ii) the interaction of financial policy with domestic capital markets, to supplement national savings efforts and match them to investment needs.

Promoting a strategy of changing production patterns with social equity requires, at the strictly macroeconomic level, efforts to manage aggregate demand and its composition. The instruments available for this purpose are fiscal, monetary and exchange rate policies. In the absence of an active fiscal policy, these instruments are reduced to simultaneously controlling the real interest rate (as a monetary policy instrument to stabilize and control aggregate domestic expenditure) and the real exchange rate (as a trade policy instrument to promote the growth of tradables production and influence the composition of aggregate expenditure).

A conflict arises when domestic interest rate consistent with the objective of curbing inflation and stabilizing economic activity (by sterilizing the monetary effects of accumulating reserves) is higher than the international rate, adjusted for expectations of devaluation, thereby providing an incentive for the inflow of capital and promoting exchange rate appreciation, thus jeopardizing the objective of protecting the economy's tradables sector. Conversely, if real domestic interest rates are allowed to fall, both objectives are thwarted, since the higher expenditure induced by lower interest rates will put pressure on prices and rapidly boost the current account deficit, threatening to cause an unsustainable macroeconomic imbalance. The authorities can resolve this conflict by acting directly or indirectly on capital flows, as some Latin American and Caribbean countries have been doing in the 1990s.

When the authorities are faced with an unexpected abundance of external financing which they consider to be partly transitory or as flowing too fast for the economy to absorb, they can intervene at three levels. At the first level, they can act to moderate this inflow's impact on the exchange rate through the purchase of foreign exchange (i.e., the accumulation of reserves) by the Central Bank. At the second level, they can adopt sterilization policies to mitigate the monetary impact of the accumulation of reserves at the first level of intervention. At the third level, they can adopt policies on incentives, surcharges or quantitative controls to regulate inflows of capital, thereby influencing the latter's composition and volume, the aim being to encourage flows whose volume is compatible with the economy's domestic absorptive capacity, channelling them into productive investment projects, and, conversely, to discourage the entry of short-term speculative capital.

In sum, governments have two alternatives. Some have opted for what is known as non-sterilized intervention, meaning that they intervene at the first level by having the Central Bank buy foreign exchange, without sterilizing the resulting monetary effect. In choosing this alternative, while also liberalizing capital movements and maintaining a nominal exchange rate with a predetermined rate of variation, the authorities lose control over monetary aggregates. The other alternative, known as sterilized intervention, broadens the scope of the first alternative by offsetting the monetary impact of the accumulation of reserves with active operations to regulate the money supply. This is intended to keep the real exchange rate within desirable ranges according to medium- and long-term objectives.

Since most countries in the region have at some point opted for sterilized intervention, they have faced serious conflicts between exchange rate and monetary management. To moderate such conflicts, they have used supplementary measures, such as providing for a degree of flexibility

in fiscal policy in order to regulate aggregate demand; stabilization funds for the main export products to cushion shocks in their price cycles (as in the case of Chilean copper and Colombian coffee); and income policies to adapt the relative prices of factors to changes in productivity.

As mentioned earlier, when fiscal policy has no instruments through which it can act flexibly, monetary policy (interest rates) and exchange rate policy (exchange rates) are the only means of controlling aggregate demand. To resolve the conflict that could arise in the simultaneous management of these two variables, the authorities have the option of intervening at the third level with measures intended to change the volume and composition of capital flows, giving priority to long-term flows through incentives (reserve requirements or taxes, and exchange rate measures that create more uncertainty for short-term capital flows) or quantitative controls.

Some direct quantitative controls include requirements as to minimum maturity periods; minimum volumes for bond issues; and regulations on the participation of foreign capital in the stock market.

In the area of exchange rate management, the aim is not only to lessen trends towards real appreciation but also to discourage international interest rate arbitrage, particularly by increasing uncertainty as to short-term trends in currency prices through mechanisms which give the authorities a wider margin for intervention. For example, one option is to allow "dirty" floating within a pre-established band, in relation to a benchmark value for the currency which has been fixed according to the market conditions of the different trading partners.

In the current circumstances of abundant external funds and comparatively low international interest rates, third-level intervention policies and sterilized intervention act on monetary aggregates to prevent overspending (especially private spending), forestalling artificial, temporary increases in domestic spending which could cause severe declines in national savings and excessive increases in external liabilities, without a corresponding increase in the capacity to produce tradables.

The extent to which foreign capital flows can further a strategy of changing production patterns with social equity largely depends on the characteristics of domestic financial markets. This observation is based on the experience of the external debt crisis, which resulted from large-scale inflows of foreign bank credits.

The reorganization of financial systems, including the liberalization of capital movements, should give priority to channelling resources into savings and investment, in close coordination with the development of productive capacity. The relationship between the financial system and national savings and investment processes, and between the financial system and external financial markets, must be considered more carefully.

Where the relationship between financial markets and capital formation for development is concerned, an institutional framework is needed to complete or perfect markets according to three criteria. The first is that a segment of the dynamic long-term financial market must be included in order to finance productive projects. This involves discouraging speculative segments and concentrating on long-term international capital accompanied by access to technology and to export markets. Capital entering the region through foreign direct investment is important in this context.

The second criterion is that the institutional framework must promote access to financing for small and medium-sized firms hurt by the segmentation of the capital market. To that end, this market must operate with some selection criteria that target the training, development promotion and modernization needs of small production enterprises. Credit institutions and guarantee mechanisms are needed to do what the region's capital markets have failed to do spontaneously. The aim is not to subsidize the cost of credit, but to pro-

mote access to financing at normal interest rates, as well as the access to technology, inputs and services, marketing channels, long-term financing and infrastructure that will enhance the productive capacity of these population sectors.

Third, it must be recognized that, in countries with "emerging" stock markets, financial liberalization of the capital account by opening it to international portfolio investment runs the risk of creating external debt overhang and excessive stock market and exchange rate fluctuations. Large-scale inflows of foreign capital to domestic markets can trigger both "stock market bubbles" and appreciation of the local currency at the same time. The subsequent decline in stock market levels can, in turn, cause capital outflows and depreciation of the currency. This means that financial institutions operating in capital markets must be regulated and supervised to ensure their stability.

Concern about such risks associated with financial markets as the generation of speculative "bubbles", adverse selection and moral hazards has meant emphasizing the need to introduce regulatory and supervisory mechanisms to ensure the stability of financial institutions operating in capital markets. Such mechanisms are particularly essential in open, free-market economies. By contrast with what happened during the debt crisis, when prudential financial regulation was weakened, strengthening such regulation can counter the above risks and contribute to a more orderly, stable process of attracting portfolio investments from abroad.

To sum up, the region's economies can make more positive use of the opportunity afforded by access to international financial markets if domestic economic policy manages to achieve the following three objectives:

i) Ensure stable access to foreign capital flows, making sure that such flows do not contribute to distortions in key economic variables such as the exchange rate and the interest rate. The exchange rate must be such as to stimulate the international competitiveness of the production sector, while real interest rates must remain at relatively low levels (although without generating an excessive level of aggregate demand) in order to encourage national private investment, reduce risks of insolvency in the financial system and avoid macroeconomic distortions. A number of countries in the region have opted for simultaneous intervention in the foreign exchange and money markets, accompanied by such measures as reserve requirements and taxes and other disincentives to short-term capital movements.

ii) Attempt to ensure that a large proportion of resources are channelled to efficient investments which enhance the international competitiveness of the region's economies. To achieve this, such resources must be absorbed in the context of an export-promotion policy that is based on a realistic, stable exchange rate appropriate to the medium-term economic situation and is supplemented by adequate technological and human resources development. This could generate sufficient external resources to avoid future debt crises. It therefore seems advisable to strengthen the region's financial markets, developing their long-term segment and reducing the impact of segmentation, so that they do, in effect, allocate resources on the basis of a cost-benefit analysis of projects.

iii) Step up the supervision and regulation (particularly prudential) of financial institutions to ensure that the increase in assets and liabilities generated by external flows does not put pressure on their future solvency.

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